AUTHENTICATED U.S. GOVERNMENT INFORMATION GPO

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9564]

RIN 1545–BJ93

Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations that provide guidance on the application of sections 162(a) and 263(a) of the Internal Revenue Code to amounts paid to acquire, produce, or improve tangible property. The temporary regulations clarify and expand the standards in the current regulations under sections 162(a) and 263(a) and provide certain bright-line tests (for example, a de minimis rule for certain acquisitions) for applying these standards. The temporary regulations also provide guidance under section 168 regarding the accounting for, and dispositions of, property subject to section 168. The temporary regulations also amend the general asset account regulations. The temporary regulations will affect all taxpayers that acquire, produce, or improve tangible property. The text of the temporary regulations also serves as the text of proposed regulations set forth in the notice of proposed rulemaking on this subject appearing elsewhere in this issue of the **Federal Register**.

DATES: *Effective Date:* These regulations are effective on January 1, 2012.

Applicability Dates: For dates of applicability of the temporary regulations, see §§ 1.162–3T, 1.162–4T, 1.162–11T, 1.165–2T, 1.167(a)–4T, 1.167(a)–7T, 1.167(a)–8T, 1.168(i)–1T, 1.168(i)–7T, 1.168(i)–8T, 1.263(a)–1T, 1.263(a)–2T, 1.263(a)–3T, 1.263(a)–6T, 1.263A–1T, and 1.1016–3T.

FOR FURTHER INFORMATION CONTACT: Concerning §§ 1.162–3T, 1.162–4T, 1.162–11T, 1.263(a)–1T, 1.263(a)–2T, 1.263(a)–3T, 1.263(a)–6T, Merrill D. Feldstein or Alan S. Williams, Office of Associate Chief Counsel (Income Tax & Accounting), (202) 622–4950 (not a toll-free call); Concerning §§ 1.165–2T, 1.167(a)–4T, 1.167(a)–7T, 1.167(a)–8T, 1.168(i)–1T, 1.168(i)–7T, 1.168(i)–8T, 1.263A–1T, and 1.1016–3T, Kathleen Reed or Patrick Clinton, Office Associate Chief Counsel (Income Tax & Accounting), (202) 622–4930 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

Section 263(a) provides that no deduction is allowed for (1) any amount paid out for new buildings or permanent improvements or betterments made to increase the value of any property or estate, or (2) any amount expended in restoring property or in making good the exhaustion thereof for which an allowance has been made. Regulations issued under section 263(a) provided that capital expenditures included amounts paid or incurred to (1) add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or (2) adapt the property to a new or different use. However, those regulations also provided that amounts paid or incurred for incidental repairs and maintenance of property within the meaning of section 162 and § 1.162–4 of the Income Tax Regulations are not capital expenditures under § 1.263(a)–1.

The United States Supreme Court has recognized the highly factual nature of determining whether expenditures are for capital improvements or for ordinary repairs. *See Welch* v. *Helvering,* 290 U.S. 111, 114 (1933) (''decisive distinctions [between capital and ordinary expenditures] are those of degree and not of kind''); *Deputy* v. *du Pont,* 308 U.S. 488, 496 (1940) (each case ''turns on its special facts''). Because of the factual nature of the issue, the courts have articulated a number of ways to distinguish between deductible repairs and non-deductible capital improvements. For example, in *Illinois Merchants Trust Co.* v. *Commissioner,* 4 B.T.A. 103, 106 (1926), acq. (V–2 CB 2), the court explained that repair and maintenance expenses are incurred for the purpose of keeping property in an ordinarily efficient operating condition over its probable useful life for the uses for which the property was acquired. Capital expenditures, in contrast, are for replacements, alterations, improvements, or additions that appreciably prolong the life of the property, materially increase its value, or make it adaptable to a different use. In *Estate of Walling* v. *Commissioner,* 373 F.2d 190, 192–193 (3rd Cir. 1966), the court explained that the relevant distinction between capital improvements and repairs is whether the expenditures were made to ''put'' or ''keep'' property in efficient operating condition. In *Plainfield-Union Water Co.* v. *Commissioner,* 39 T.C. 333, 338 (1962), nonacq. on other grounds (1964–2 CB 8), the court stated that if the expenditure merely restores the property to the state it was in before the situation prompting the expenditure arose and does not make the property more valuable, more useful, or longer-lived, then such an expenditure is usually considered a deductible repair. In contrast, a capital expenditure is generally considered to be a more permanent increment in the longevity, utility, or worth of the property.

The standards for applying section 263(a), as set forth in the regulations, case law, and administrative guidance, are difficult to discern and apply in practice and have led to considerable uncertainty and controversy for taxpayers. On January 20, 2004, the IRS and the Treasury Department published Notice 2004–6 (2004–3 IRB 308) announcing an intention to propose regulations providing guidance in this area. The notice identified issues under consideration by the IRS and the Treasury Department and invited public comment on whether these or other issues should be addressed in the regulations and, if so, what specific rules and principles should be provided.

On August 21, 2006, the IRS and the Treasury Department published in the **Federal Register** (71 FR 48590–01) proposed amendments to the regulations under section 263(a) (2006 proposed regulations) relating to amounts paid to acquire, produce, or improve tangible property. The IRS and the Treasury Department received numerous written comments on the 2006 proposed regulations and held a public hearing on December 19, 2006. On March 10, 2008, after consideration of the comment letters and the statements at the public hearing, the IRS and the Treasury Department withdrew the 2006 proposed regulations and proposed new regulations (2008 proposed regulations) in the **Federal Register** (73 FR 47 12838–01) under sections 162(a) (relating to the deduction for ordinary and necessary trade or business expenses) and section 263(a) (relating to the capitalization requirement). The IRS and the Treasury Department received several comment letters on the 2008 proposed regulations and held a public hearing on the 2008 proposed regulations on June 24, 2008. After considering the comment letters and the statements at the public hearing, the IRS and the Treasury Department are issuing temporary regulations amending 26 CFR part 1. The IRS and the Treasury Department are also withdrawing the 2008 proposed regulations and are proposing new regulations that incorporate the text of these temporary regulations.

Explanation of Provisions

I. Overview

Section 263(a) generally requires the capitalization of amounts paid to acquire, produce, or improve tangible property. These temporary regulations provide a general framework for capitalization and retain many of the provisions of the 2008 proposed regulations, which in many instances incorporated standards from existing authorities under section 263(a). The temporary regulations also modify several sections of the 2008 proposed regulations in response to comments received and to achieve results that are more consistent with the established authorities. The temporary regulations adopt the same general format as the 2006 and 2008 proposed regulations, whereby § 1.263(a)–1T provides general rules for capital expenditures, § 1.263(a)–2T provides rules for amounts paid for the acquisition or production of tangible property, and § 1.263(a)–3T provides rules for amounts paid for the improvement of tangible property. The temporary regulations also adopt and refine many of the rules contained in the 2008 proposed regulations. For example, the temporary regulations adopt and refine the definition and treatment of materials and supplies under § 1.162–3T, the de minimis rule for the acquisition and production of property under § 1.263(a)–2T, and the safe harbor for routine maintenance under § 1.263(a)–3T.

The temporary regulations also modify some of the rules set out in the 2008 proposed regulations. For example, the temporary regulations revise certain rules for determining whether there has been an improvement to a unit of property under § 1.263(a)–3T. Notably, the temporary regulations revise the rules for determining whether an amount is paid for an improvement to a building. The temporary regulations also revise the rule for determining whether an amount is paid for the replacement of a major component or substantial structural part of a unit of property. In addition, the temporary regulations include numerous new and revised examples to illustrate the application of the improvement rules. Finally, the temporary regulations provide several additional rules that were not included in the 2008 proposed regulations. For example, the temporary regulations provide rules under § 1.263(a)–3T(f) for the treatment of amounts paid to improve leased property and provide rules under § 1.168(i)–8T that revise the definition of *disposition* for property subject to section 168 to include the retirement of a structural component of a building.

II. Materials and Supplies Under § 1.162–3

Section 1.162–3 provides, in part, that a taxpayer carrying materials and supplies on hand should include in expenses the charges for materials and supplies only in the amount that are actually consumed and used in operation during the taxable year for which the return is made. Section 1.162–3 does not define materials and supplies; however various judicial and administrative authorities have ruled on whether property constitutes a material or supply (rather than inventory or depreciable property). *See,* for example, Rev. Rul. 81–185 (1981–2 CB 59); Rev. Rul. 78–382 (1978–2 CB 111).

In response to practitioner comments that the 2006 proposed regulations failed to address the relationship between the treatment of acquisition costs and the treatment of materials and supplies, the 2008 proposed regulations proposed substantial modifications to § 1.162–3. The 2008 proposed regulations defined materials and supplies as tangible property that is used or consumed in the taxpayer's operations that (1) is not a unit of property or acquired as part of a single unit of property; (2) is a unit of property that had an economic useful life of 12 months or less, beginning when the property was used or consumed; (3) is a unit of property that had an acquisition or production cost (as determined under section 263A) of $100 or less; or (4) is identified as a material and supply in future published guidance. In addition, the 2008 proposed regulations adopted the general rule that incidental materials and supplies (for which no inventories or records of consumption are maintained) are deductible in the year purchased and that non-incidental materials and supplies are not deductible until the year in which they are used or consumed in the taxpayer's operations.

The 2008 proposed regulations included a specific rule for the treatment of rotable or temporary spare parts that otherwise met the definition of materials and supplies. Because rotable and temporary spare parts are typically removed, repaired, and reused over a period of years, the 2008 proposed regulations treated rotable and temporary spare parts as used or consumed in the taxable year in which a taxpayer disposed of the rotable or temporary part.

The temporary regulations generally retain the framework set forth in the 2008 proposed regulations for materials and supplies. In response to practitioner and industry comments, however, the temporary regulations modify and expand the definition of materials and supplies, provide an alternative optional method of accounting for rotable and temporary spare parts, and provide an election to treat certain materials and supplies under the de minimis rule of § 1.263(a)–2T. In addition, consistent with the 2008 proposed regulations, the temporary regulations allow a taxpayer to elect to capitalize certain materials and supplies.

A. Definition of Materials and Supplies

The 2008 proposed regulations defined the first category of materials and supplies as tangible property used and consumed in the taxpayers operations, not constituting a unit of property under § 1.263(a)–3(d)(2), and not acquired as part of a single unit of property. Under this definition, many component parts acquired separately from an existing unit of property would not be treated as materials and supplies if they were treated as separate units of property under § 1.263(a)–3(d)(2). The IRS and the Treasury Department intended that these components generally qualify as materials and supplies. Therefore, the temporary regulations redefine the first category of materials and supplies by further describing the types of components that qualify and by eliminating the requirement that such property not be a unit of property under section § 1.263(a)–3T(d)(2). Under the temporary regulations, the first category of materials and supplies includes components that are acquired to maintain, repair, or improve a unit of tangible property owned, leased, or serviced by the taxpayer and that are not acquired as part of any single unit of property.

In addition, the temporary regulations provide a new category of materials and supplies. One commentator suggested that the IRS and the Treasury Department consider the treatment of certain property that does not fit clearly into any of the categories set out in the 2008 proposed regulations but that generally is not considered depreciable property or inventory property, such as fuel, water, or lubricants. The temporary regulations add a category of materials and supplies for fuel, lubricants, water, and similar items that are reasonably expected to be consumed in 12 months or less, beginning when used in the taxpayer's operations.

In addition, the IRS and the Treasury Department received several comments requesting that the definition of materials and supplies raise the specified acquisition or production cost threshold from $100 or less to $500 or less and that this specified amount be indexed for inflation. The temporary regulations retain the $100 limitation to avoid possible inappropriate distortions of a taxpayer's income. The temporary regulations add language, however, that gives the IRS and the Treasury Department the flexibility to change the amount of the limitation by future published guidance. Moreover, a taxpayer with applicable financial statements will be permitted to deduct amounts paid for property up to higher thresholds if it complies with the requirements set out in the de minimis rule provided in § 1.263(a)–2T.

Finally, several commentators questioned the effect of proposed § 1.162–3 on certain safe harbor revenue procedures that permit taxpayers to treat certain property as materials and supplies. For example, Rev. Proc. 2002–12 (2002–1 CB 374) allows a taxpayer to treat smallwares as materials and supplies that are not incidental under § 1.162–3. Similarly, Rev. Proc. 2002–28 (2002–1 CB 815) allows a qualifying small business taxpayer to treat certain inventoriable items in the same manner as materials and supplies that are not incidental under § 1.162–3. The temporary regulations do not supersede, obsolete, or replace these revenue procedures to the extent they deem certain property to constitute materials and supplies under § 1.162–3. This designated property continues to qualify as materials and supplies under the temporary regulations because the property is identified in published guidance as materials and supplies.

B. Optional Method for Rotable or Temporary Spare Parts

The 2008 proposed regulations proposed to allow a deduction for amounts paid for rotable or temporary spare parts when the parts were discarded from the taxpayer's operations. Alternatively, a taxpayer could elect to capitalize and depreciate rotable spare parts over the parts' applicable recovery period.

The IRS and the Treasury Department received comments stating that the requirement to defer the deduction of rotable spare parts until the year of disposition is inconsistent with the method that many taxpayers currently use for rotable spare parts and would result in an administrative burden for those taxpayers. One commentator explained that, under this method, a taxpayer deducts an amount paid for a new rotable spare part in the taxable year in which it installs the rotable part in its equipment. The taxpayer includes in income and assigns a cost basis equal to the fair market value of the used, non-functioning part, and capitalizes the costs of repairing the part. If the repaired part is later used as a replacement part in the taxpayer's equipment, the taxpayer deducts the basis of the part in the taxable year it is re-installed. This cycle continues until disposition of the part.

The temporary regulations generally adopt the recommendations of the commentator and include the proposed method of accounting for rotable parts as an optional method. This optional method may be used as an alternative to treating the parts as used or consumed in the year of disposition or electing to treat the parts as depreciable assets. If a taxpayer chooses to use the optional method, the method must be used for all of the taxpayer's rotable and temporary spare parts in the same trade or business.

C. Election To Deduct Materials and Supplies Under the De Minimis Rule

The IRS and the Treasury Department received several comments requesting that the regulations clarify whether a taxpayer may apply the de minimis rule contained in § 1.263(a)–2 of the 2008 proposed regulations to units of property that were also treated as materials and supplies under § 1.162–3 of the proposed regulation. Under the proposed de minimis rule, a taxpayer was not required to capitalize amounts paid for the acquisition or production of a unit of property if the taxpayer met certain requirements set out in that regulation. The proposed de minimis rule provided a taxpayer with more favorable treatment (that is, deduction when an amount is paid or incurred) than the treatment of materials and supplies under the general rule of § 1.162–3 (that is, deduction when property is used or consumed). Commentators indicated that the requirement to differentiate and separately account for certain materials and supplies is impractical and presents an administrative burden that is inconsistent with the purpose of the de minimis rule. Thus, commentators requested that a taxpayer be permitted to apply the de minimis rule of § 1.263(a)–2, rather than the materials and supplies rules, to the costs of any unit of property that meets the definition of materials and supplies.

The temporary regulations adopt this recommendation and allow a taxpayer to elect to apply the de minimis rule of § 1.263(a)–2T(g) to the costs of acquiring or producing any type of material or supply defined in § 1.162–3T if such costs meet the requirements of the de minimis rule. Thus, a taxpayer may apply a single timing rule (that is, deduction when paid or incurred) to any unit of property, including materials and supplies, to the extent the aggregate amount paid for such property does not exceed the limit described in § 1.263(a)–2T(g)(1)(iv).

D. Election To Capitalize Materials and Supplies

The temporary regulations retain the rule from the 2008 proposed regulations that permits a taxpayer to elect to capitalize and depreciate amounts paid for certain materials and supplies. Several commentators questioned the effect of this provision and the other new rules under proposed § 1.162–3 on previous IRS pronouncements that distinguished certain depreciable property from materials and supplies. *See,* for example, Rev. Rul. 2003–37 (2003–1 CB 717) (permitting taxpayers to treat certain rotable spare parts used in a service business as depreciable assets); Rev. Rul. 81–185 (1981–2 CB 59) (concluding that major standby emergency spare parts are depreciable property); Rev. Rul. 69–201 (1969–1 CB 60) (holding that standby replacement parts used in pit mining business are items for which depreciation is allowable); Rev. Rul. 69–200 (1969–1 CB 60) (holding that flight equipment rotatable spare parts and assemblies are tangible property for which depreciation is allowable while expendable flight equipment spare parts are materials and supplies); Rev. Proc. 2007–48 (2007–2 CB 110) (providing a safe harbor method of accounting to treat certain rotable spare parts as depreciable assets).

Section 1.162–3T is applicable to all materials and supplies as defined under that provision, including certain types of property that were treated as depreciable property under previously published guidance. Thus, for example, the temporary regulations modify Rev. Rul. 2003–37, Rev. Rul. 81–185, Rev. Rul. 69–200, and Rev. Rul. 69–201 to the extent that the temporary regulations characterize certain tangible properties addressed in these rulings as materials and supplies. However, the temporary regulations permit taxpayers to elect to treat these properties as assets subject to the allowance for depreciation consistent with the holdings in these revenue rulings. In addition, the IRS and the Treasury Department recognize that Rev. Proc. 2007–48 may need to be revised to address the treatment of certain rotable spare parts defined as materials and supplies under the temporary regulations. Thus, comments are requested on the application of the safe harbor method in this context.

III. Repairs Under § 1.162–4

The 2008 proposed regulations proposed to revise § 1.162–4 (the repairs regulation) to provide rules consistent with the improvement rules under § 1.263(a)–3 of the proposed regulations. The 2008 proposed regulations provided that amounts paid for repairs and maintenance to tangible property are deductible if the amounts paid are not required to be capitalized under § 1.263(a)–3. The IRS and Treasury Department received no comments on this proposed regulation. The temporary regulations retain the rule from the 2008 proposed regulations and clarify that a taxpayer is permitted to deduct amounts paid to repair and maintain tangible property provided such amounts are not required to be capitalized under section 263(a) or any other provision of the Code or regulations. See, for example, section 263A and the regulations thereunder.

IV. Rentals Under § 1.162–11 and Leased Property Under § 1.167(a)–4

The existing regulations under § 1.162–11 provide rules for the treatment of amounts paid (1) to acquire a leasehold and (2) for leasehold improvements by a lessee on a lessor's property. The temporary regulations do not amend the rule in § 1.162–11(a) that provides that a taxpayer may amortize the cost of acquiring a leasehold over the term of the lease. The temporary regulations make only minor revisions to the rule in § 1.162–11(b) that provides that the cost of erecting a building or making a permanent improvement to property leased by the taxpayer is a capital expenditure and is not deductible as a business expense.

Section 1.162–11(b) of the existing regulations also provides that a taxpayer lessee may amortize a leasehold improvement over the shorter of the estimated useful life of the improvement or the remaining period of the lease. A similar rule exists in § 1.167(a)–4. In that respect, the existing regulations do not reflect the amendments made to sections 168 and 178 by sections 201(a) and 201(d)(2)(A), respectively, of the Tax Reform Act of 1986, Public Law 99–514. See sections 168(i)(6) and (8), which require a lessee or lessor to depreciate or amortize leasehold improvements under the cost recovery provisions of the Code applicable to the improvements, without regard to the term of the lease. Accordingly, the temporary regulations both amend the rules in §§ 1.162–11(b) and 1.167(a)–4 to provide that a lessee or lessor must depreciate or amortize its leasehold improvements under the cost recovery provisions of the Internal Revenue Code applicable to the improvements, without regard to the term of the lease, and also remove the rules permitting amortization over the shorter of the estimated useful life or the term of the lease. For example, if the leasehold improvement is property to which section 168 applies, the leasehold improvement is depreciated under section 168. Section 1.162–11 of the temporary regulations also includes cross references to § 1.263(a)–3T(f)(1) (regarding improvements to leased property) and to § 1.167(a)–4T (regarding depreciation or amortization deductions for leasehold improvements).

V. Amounts Paid To Acquire or Produce Tangible Property Under § 1.263(a)–2T

The 2008 proposed regulations provided rules for the capitalization of amounts paid to acquire or produce units of tangible property. The temporary regulations retain most of these rules, including the general requirement to capitalize acquisition and production costs, and the requirement to capitalize amounts paid to defend and perfect title to property. In response to comments received, the temporary regulations clarify the application of the rules to moving and reinstallation costs; retain the rule for costs incurred prior to placing property into service; add and clarify certain rules with respect to transaction costs; and modify and refine the de minimis rule.

A. Moving and Reinstallation Costs

An example in the 2008 proposed regulations illustrated that a taxpayer generally is not required to capitalize the costs of moving tangible personal property already placed in service from one facility to another similar facility. Several commentators expressed concern, however, that the example in the 2008 proposed regulations omitted any discussion of the treatment of amounts paid to reinstall the unit of property in the new location. Amounts paid to move and reinstall a unit of property that has already been placed in service by the taxpayer generally are not amounts paid to acquire or produce a unit of property. Thus, these costs are not required to be capitalized under the rules for acquisition or production of property. But, if the costs of moving and reinstalling a unit of property directly benefit, or are incurred by reason of, an improvement to the unit of property that is moved and reinstalled, such costs are required to be capitalized. The temporary regulations address these types of moving and reinstallation costs in examples provided in § 1.263(a)–3T(h)(4), governing improvements to property.

B. Work Performed Prior To Placing Property Into Service

The 2008 proposed regulations provided that acquisition costs include costs for work performed on a unit of property prior to the date the unit of property is placed in service. Several commentators expressed concern that this rule would require a taxpayer to capitalize generally deductible costs, such as repair costs, if they were incurred prior to placing the unit of property in service. One commentator suggested that the regulations allow a taxpayer to rebut the presumption that these costs are acquisition costs.

Amounts paid for work performed on a unit of property prior to placing the property in service are related to the acquisition of the unit of property and, therefore, must be treated as an acquisition cost. The temporary regulations do not incorporate a rebuttable presumption in this rule because there are very few, if any, costs to which the presumption would apply. Moreover, a rebuttable presumption is more subjective and difficult to administer. Thus, the temporary regulations retain the bright-line rule that requires a taxpayer to capitalize costs that are incurred prior to the date a unit of property is placed in service.

C. Transaction Costs

The 2008 proposed regulations provided that a taxpayer must, in general, capitalize amounts paid to facilitate the acquisition or production of real or personal property. They included a rule that provided that costs relating to activities performed in the process of determining whether to acquire real property and which real property to acquire generally are deductible pre-decisional costs unless they are described in the regulations as inherently facilitative costs. The temporary regulations retain the general rule in the 2008 proposed regulations and the rules defining the costs that facilitate the acquisition or production of real or tangible property. The temporary regulations also clarify that a taxpayer may be required to allocate certain facilitative costs between personal property and real property acquired in a single transaction. Accordingly, the temporary regulations add a ''reasonable allocation'' rule to assist a taxpayer in making allocations of facilitative costs between personal property and real property. In addition, the temporary regulations provide that a taxpayer may allocate inherently facilitative amounts to separate units of property that are considered, but not acquired, and recover such costs in accordance with applicable sections of the Code and regulations. The temporary regulations do not accommodate commentators' requests to extend the rule permitting deduction of certain pre-decisional costs of acquiring real property to personal property because such a rule could generate controversy over unduly small amounts.

D. De Minimis Rule

The 2008 proposed regulations provided that a taxpayer must capitalize amounts paid to acquire or produce a unit of real or personal property, including the related transaction costs. Under the proposed de minimis rule, however, a taxpayer was not required to capitalize amounts paid for the acquisition or production (including any amounts paid to facilitate the acquisition or production) of a unit of property if (1) the taxpayer had an applicable financial statement (AFS) as defined in the regulation; (2) the taxpayer had, at the beginning of the taxable year, written accounting procedures treating as an expense for non-tax purposes the amounts paid for property costing less than a certain dollar amount; (3) the taxpayer treated the amounts paid during the taxable year as an expense on its AFS in accordance with its written accounting procedures; and (4) the total aggregate of amounts paid and not capitalized for the taxable year under this provision did not distort the taxpayer's income for the taxable year (the ''no distortion requirement'').

The IRS and the Treasury Department included the no distortion requirement in the 2008 de minimis rule in an effort to limit the deduction to amounts that clearly reflected income under section 446. To ease the administrative burden of determining whether amounts expensed under the de minimis rule distorted taxable income, the 2008 proposed regulations included a safe harbor. Under this safe harbor, an amount deducted under the AFS-based de minimis rule for the taxable year would be deemed not to distort income if that amount (when added to the amounts deducted in the taxable year as materials and supplies for units of property costing $100 or less) was less than or equal to the lesser of 0.1 percent of the taxpayer's gross receipts for the taxable year or 2 percent of the taxpayer's total AFS depreciation and amortization for the taxable year. The preamble to the 2008 proposed regulations clarified that, depending on a taxpayer's particular facts and circumstances, an amount in excess of the safe harbor would not necessarily result in a distortion of income.

A number of commentators approved of the concept of an AFS-based de minimis rule but were critical of the inclusion of the no distortion requirement. The commentators expressed concern that the no distortion requirement would increase controversy, was burdensome, and was contrary to the regulation's goal of clarity and certainty. Some commentators asserted that the imposition of a financial conformity requirement on the use of a de minimis rule established its own safeguards with respect to the materiality of the deductions under the de minimis rule.

In addition, some commentators suggested that if the no distortion requirement were retained in the final regulations, the safe harbor limits should be set at a higher level. The IRS and the Treasury Department also received comment letters requesting that the de minimis rule be expanded to a taxpayer without an AFS by setting specific de minimis threshold amounts.

The de minimis rule under the temporary regulations retains the requirement that a taxpayer may deduct certain amounts paid for tangible property if the taxpayer has an AFS, has written accounting procedures for expensing amounts paid for such property under certain dollar amounts, and treats such amounts as expenses on its AFS in accordance with such written accounting procedures. However, the temporary regulations replace the no distortion requirement with an overall ceiling that generally limits the total expenses that a taxpayer may deduct under the de minimis rule. The new criteria mandates that the aggregate of amounts paid and not capitalized under the de minimis rule for the taxable year must be less than or equal to the greater of (1) 0.1 percent of the taxpayer's gross receipts for the taxable year as determined for Federal income tax purposes; or (2) 2.0 percent of the taxpayer's total depreciation and amortization expense for the taxable year as determined in its AFS.

The use of a ceiling provides an objective and administrable limit on a taxpayer's total de minimis expense deduction and does not require an independent analysis to determine whether the amount clearly reflects the taxpayer's income. While a taxpayer's treatment on its financial statements provides a reasonable foundation for determining a taxpayer's de minimis expenses, the application of certain limits, based on a percentage of gross receipts or percentage of depreciation expense, is supported by the case law and the clear reflection of income principle under section 446. *See,* for example, *Cincinnati, New Orleans & Tex. Pac. Ry. Co.* v. *United States,* 424 F.2d 563 (Ct. Cl. 1970); *Alacare Home Health Services, Inc.* v. *Commissioner,* T.C. Memo. 2001–149.

In response to several comment letters, the temporary regulations also add and modify several provisions governing the application of the de minimis rule. For example, temporary regulations eliminate the requirement in the 2008 proposed regulations that, in calculating whether a taxpayer's de minimis amount exceeds the ceiling, the taxpayer must also include the amounts deducted under proposed § 1.162–3 as materials and supplies costing $100 or less. Under the temporary regulations, amounts paid for materials and supplies are subject to the de minimis ceiling only if the taxpayer elects under § 1.162–3T to treat those materials or supplies under the de minimis rule of § 1.263(a)–2T. In addition, the temporary regulations eliminate the exceptions from the proposed de minimis rule for property acquired for repairs and property acquired for improvements. Thus, the de minimis rule may be applied to these amounts. However, the de minimis rule does not apply to amounts paid for labor and overhead incurred in repairing or improving property.

The IRS and the Treasury Department received one comment letter suggesting that that the temporary regulations clarify the application of the de minimis rule to a member of a consolidated group. In response, the temporary regulations add a provision that permits a member to utilize the written accounting procedures provided on the applicable financials statements of its affiliated group. The IRS and the Treasury Department intend to give further consideration to the application of the de minimis rule in a consolidated group setting. In this regard, the IRS and the Treasury Department request additional comments on the manner in which the de minimis rule, including the de minimis rule limitations, may be applied to, and based on, the tax and financial results of a consolidated group.

The de minimis rule in the temporary regulations is not intended to prevent a taxpayer from reaching an agreement with its IRS examining agents that, as an administrative matter, based on risk analysis or materiality, the IRS examining agents will not review certain items. It is not intended that examining agents must now revise their materiality thresholds in accordance with the de minimis rule ceiling. Thus, if examining agents and a taxpayer agree that certain amounts in excess of the de minimis rule ceiling are immaterial and should not be subject to review, that agreement should be respected, notwithstanding the requirements of the de minimis rule in the temporary regulations. However, a taxpayer that seeks a deduction for amounts in excess of the amount allowed by this rule or by agreement with IRS examining agents will have the burden of showing that such treatment clearly reflects income.

Finally, the temporary regulations do not expand the de minimis rule to a taxpayer without an AFS or provide specific de minimis amounts deductible by a taxpayer in this context. A taxpayer without an AFS does not have a consistent, audited methodology for determining de minimis expenses, and as a result, the IRS would have little or no assurance that a taxpayer without an AFS was using a reasonable, consistent methodology that clearly reflects income. However, the temporary regulations provide some relief for a taxpayer without an AFS by providing a deduction under § 1.162–3T for materials and supplies that cost $100 or less. The IRS and the Treasury Department request comments addressing de minimis rule alternatives that would substantiate the use of a reasonable and consistent methodology and ensure clear reflection of income for determining de minimis expenses for a taxpayer without an AFS.

VI. Amounts To Improve Property Under § 1.263(a)–3T

A. Overview

The temporary regulations retain the basic framework of the 2008 proposed regulations for determining the unit of property and for determining whether there is an improvement to the unit of property. The temporary regulations also retain many of the simplifying conventions set out in the 2008 proposed regulations, including the routine maintenance safe harbor and the optional regulatory accounting method. As explained below, the temporary regulations also modify the 2008 proposed regulations in several areas.

A goal of both the 2006 and 2008 proposed regulations was to reduce controversy and provide clarity in determining whether an amount is paid for an improvement that must be capitalized under section 263(a). In several respects, however, the more objective rules provided in the 2008 proposed regulations limited the circumstances in which an amount paid would be capitalized as an improvement. First, the 2008 proposed regulations defined the unit of property for a building as the building and its structural components. Thus, work performed on a building would rise to the level of an improvement only if it resulted in a betterment or restoration (or a new or different use) when applied to the building and its structural components as a whole. Second, the restoration rules under the 2008 proposed regulations provided that a taxpayer did not have to capitalize, or treat as an improvement, amounts paid to replace a major component or substantial structural part of a unit of property unless those amounts were paid after the recovery period for the property, and either (1) the replacement cost comprised 50 percent or more of the replacement cost of the entire unit of property, or (2) the replacement parts comprised 50 percent or more of the physical structure of the unit of property (''the 50 percent thresholds''). Thus, capitalization under the major component rule applied only if the property was fully depreciated and either of the 50 percent thresholds were triggered.

These sections of the 2008 proposed regulations would have led to results that were contrary to long-standing case law (discussed below) and inconsistent with the way most taxpayers had treated these items for tax purposes. Although the preamble to the 2008 proposed regulations provided that a taxpayer should not rely on the proposed rules, many taxpayers applied to change their methods of accounting from capitalizing certain expenditures to deducting these expenditures as repairs based on the standards in the 2008 proposed regulations.

The 2008 proposed regulations limited capitalization and allowed more frequent deductions for work performed on tangible property, in part, to lessen the effects of depreciation and disposition rules under section 168 (MACRS). Under section 168(i)(6), a taxpayer is required to depreciate an amount paid for an improvement using the same recovery period and the same depreciation method as the underlying property, with the recovery period beginning when the improvement is placed in service. In addition, § 1.168–2(l)(1) of the proposed ACRS regulations (which have been generally applied to MACRS property) provides that a disposition does not include the retirement of a structural component of a building. Accordingly, § 1.168–6(b) of the proposed ACRS regulations provides that no loss shall be recognized upon the retirement of a structural component of a building. Thus, if a taxpayer replaced a structural component of a building during the recovery period of the building, the taxpayer could not immediately recover the basis allocable to the removed component, but rather had to continue to depreciate it as part of the building. If the taxpayer were required to capitalize the costs of the replacement component under section 263(a), then the taxpayer would be required to depreciate contemporaneously both the retired component and the replacement component.

To achieve results more consistent with existing law and to provide relief from the potential inequities that can result from the application of the depreciation and disposition rules, the temporary regulations revise and amend the 2008 proposed regulations in several respects. First, the temporary regulations retain the rule from the 2008 proposed regulations that the unit of property for a building consists of the building and its structural components. However, the temporary regulations revise the manner in which the improvement standards must be applied to the building and its structural components. In determining whether an amount paid is for an improvement to the building, the temporary regulations require a taxpayer to consider the effect of the expenditure on certain significant and specifically defined components of the building, rather than the building and its structural components as a whole. Second, the temporary regulations do not include the 50 percent thresholds and recovery period limitation for determining whether a replacement rises to the level of a major component or substantial structural part of a unit of property. Finally, the temporary regulations include new provisions under section 168 that expand the definition of dispositions to include the retirement of a structural component of a building. This change allows a taxpayer to recognize a loss on the disposition of a structural component of a building before the disposition of the entire building, so that a taxpayer will not have to continue to depreciate amounts allocable to structural components that are no longer in service. Thus, under the temporary regulations, a taxpayer is not required to capitalize and depreciate simultaneously amounts paid for both the removed and the replacement properties.

The IRS and the Treasury Department recognize that it may be difficult for taxpayers to determine specifically the amount of the adjusted basis of the property that is allocable to the retired component. This difficulty may be particularly acute in industries where a taxpayer has capitalized a number of improvements as part of cyclical remodels or renovations. Comments are requested on computational methodologies or safe harbors that a taxpayer may use to simplify this determination.

In addition to these changes, the temporary regulations incorporate more detailed rules for determining the units of property for condominium, cooperatives, and leased property, for the treatment of leasehold improvements, and for additional costs incurred during an improvement, such as related repair and maintenance costs. The temporary regulations also clarify various examples and add new examples illustrating the treatment of items such as moving and reinstallation costs, retail remodeling costs, and the costs of replacing major components.

B. Determining the Unit of Property

1. Overview

The 2008 proposed regulations generally defined a unit of property as consisting of all the components of the unit of property that are functionally interdependent. The proposed regulations, however, provided special rules for determining the unit of property for buildings, plant property, and network assets. For property other than buildings, the 2008 proposed regulations further refined the units of property by treating a functionally interdependent component as a separate unit of property if the taxpayer initially assigned a different economic useful life to the component for financial statement or regulatory purposes or if the taxpayer assigned a different MACRS class or recovery method to the component. The temporary regulations retain most of these rules for determining units of property, with minor exceptions. In addition, the temporary regulations clarify the application of the improvement rules to the unit of property for buildings and set out more detailed rules for applying these rules to condominiums, cooperatives, and leased property. The temporary regulations also contain new and revised provisions addressing the treatment of, and the unit of property determination for, leasehold improvements.

2. Buildings and Structural Components

The 2008 proposed regulations retained the rule from the 2006 proposed regulations that the building (as defined in § 1.48–1(e)(1)) and its structural components (as defined in § 1.48–1(e)(2)) are a single unit of property. In response to the 2008 proposed regulations, the IRS and the Treasury Department did not receive any comments addressing the unit of property for buildings. After issuance of the 2008 proposed regulations, however, many taxpayers claimed that major work performed on buildings did not result in an improvement because the work affected only a small portion of the unit of property, that is, the entire building. Under this analysis, for example, taxpayers claimed that the costs of new roofs, replacements of entire heating and air conditioning systems, and major structural changes to building interiors were all deductible as repairs or maintenance. Moreover, taxpayers may have viewed the 50 percent thresholds and recovery period limitation exceptions to the major component and substantial structural part rule as consistent with the conclusion that these types of expenses should generally be treated as deductible repair or maintenance costs. Although the preamble to the 2008 proposed regulations explicitly stated that a taxpayer should not rely on the proposed rules, many taxpayers regarded these rules as the IRS's and the Treasury Department's interpretation of current law.

The temporary regulations revise the 2008 standards in several respects to achieve results that are more consistent with current law. The temporary regulations retain the general rule that the unit of property for a building is comprised of the building and its structural components. The temporary regulations, however, require that a taxpayer apply the improvement standards separately to the primary components of the building, that is, the building structure or any of the specifically defined building systems. Thus, a cost is treated as a capital expenditure if it results in an improvement to the building structure or to any of the specifically enumerated building systems. The temporary regulations define the building structure as the building (as defined in § 1.48–1(e)(1)) and its structural components (as defined in § 1.48–1(e)(2)) other than the components specifically enumerated as building systems. The temporary regulations define building systems to include (1) the heating, ventilation, and air conditioning systems (''HVAC''); (2) the plumbing systems; (3) the electrical systems; (4) all escalators; (5) all elevators; (6) the fire protection and alarm systems; (7) the security systems; (8) the gas distribution systems; and (9) any other systems identified in published guidance.

Accordingly, if an amount paid results in a restoration of a building structure, such as the replacement of an entire roof, then under the temporary regulations the expenditure constitutes an improvement to the building unit of property. Similarly, if an amount paid results in a betterment to a building system, such as an improvement to the HVAC system, then the expenditure also constitutes an improvement to the building unit of property. Compared to the approach provided in the 2008 proposed regulations, the approach contained in these temporary regulations produces results that are more consistent with current law. *See,* for example, *Smith* v. *Commissioner,* 300 F.3d 1023 (9th Cir. 2002) (holding that costs to replace a substantial portion of floor were capital expenditures); *Tsakopoulous* v. *Commissioner,* T.C. Memo. 2002–8 (holding that costs to replace the roof on a portion of the suites of a shopping center were capital expenditures); *Hill* v. *Commissioner,* T.C. Memo. 1983–112 (holding that costs to replace the water heater and furnace in rental property were capital expenditures); *Stewart Supply Co.* v. *Commissioner,* T.C. Memo. 1963–62 (holding that costs to replace the front wall of a building and make electrical connections to that wall were capital expenditures); *First Nat'l Bank* v. *Commissioner,* 30 B.T.A. 632 (1934) (holding that costs of replacing the electrical system in a bank building were capital expenditures); *Georgia Car and Locomotive Co.,* 2 B.T.A. 986 (1925) (holding that costs of a new roof on a building were capital expenditures). The approach for buildings is conceptually similar to the plant property rule discussed below, which segregates plant property into units of property that perform discrete and major functions within the plant.

a. Condominiums and Cooperatives

The 2008 proposed regulations provided that the unit of property for a condominium was the individual unit owned by the taxpayer and that the unit of property for a cooperative was the individual unit possessed by the taxpayer. The temporary regulations provide additional detail defining the unit of property for condominiums and cooperatives and provide additional guidance for applying the improvement rules to these units of property. The temporary regulations provide that for the owner of a condominium, the unit of property is the individual unit owned by the taxpayer and the structural components that are part of the condominium unit. Similarly, for a taxpayer that has an ownership interest in a cooperative housing corporation, the unit of property is the portion of the building in which the taxpayer has possessory rights and the structural components that are part of the portion of the building subject to the taxpayer's possessory rights. For both condominiums and cooperatives, however, the temporary regulations provide that an amount is paid for an improvement to these units of property if the amount results in an improvement to the building structure that is part of the condominium or cooperative unit or to the portion of any building system that is part of the condominium or cooperative unit.

b. Leased Buildings (Taxpayer as Lessee)

The 2008 proposed regulations did not address the unit of property for leased property. The IRS and the Treasury Department received several comments requesting that the regulations include more detailed rules regarding the unit of property for leased property and the unit of property for leasehold improvements. The temporary regulations define the unit of property for leased buildings and provide that if a taxpayer is a lessee of all or a portion of one or more buildings (such as an office, floor, or certain square footage), the unit of property is each building and its structural components or the portion of each building subject to the lease and the structural components associated with the leased portion. The temporary regulations also provide that an amount is paid for an improvement to a leased building or a leased portion of a building if the amount paid results in an improvement to the leased building structure (or the portion thereof subject to the lease) or any of the leased building systems (or the portion thereof subject to the lease).

3. Property Other Than Buildings

The 2008 proposed regulations generally defined the unit of property for real and personal property other than buildings to include all functionally interdependent components. Components were defined as functionally interdependent if placing one component in service depends on placing the other component in service. Special rules were provided for plant property and network assets.

The temporary regulations retain the functional interdependence test as the general rule for determining the unit of property for real and personal property other than buildings. The temporary regulations also continue to provide special rules for plant property and network assets. However, the temporary regulations remove the rule requiring taxpayers to treat a functionally interdependent component as a separate unit of property if the taxpayer initially assigned a different economic useful life to the component for financial statement or regulatory purposes. In addition, the temporary regulations include a rule for determining the unit of property for leased property other than buildings.

a. Plant Property

Under the 2008 proposed regulations, a unit of property for plant property generally was comprised of each component (or group of components) within the plant that performs a discrete and major function or operation within functionally interdependent machinery or equipment. The discrete and major function rule provides a reasonable and administrable limitation on the functional interdependence standard, which otherwise could be overly broad in its application to industrial equipment. Accordingly, the temporary regulations retain the plant property rule as it was proposed in the 2008 proposed regulations.

b. Network Assets

The 2008 proposed regulations generally defined network assets as railroad track, oil and gas pipelines, water and sewage pipelines, power transmission and distribution lines, and telephone and cable lines but reserved defining the unit of property for network assets in specific industries. The preamble to the 2008 proposed regulations invited industries with network assets to request guidance under the Industry Issue Resolution (''IIR'') program. Although several commentators requested that the regulations provide guidance on the units of property for network assets, given the detailed factual issues underpinning the proper treatment of such assets, the units of property for network assets are more appropriately determined through guidance tailored to individual industries under the IIR program. The IRS and the Treasury Department have accepted IIR requests from several industries to develop industry specific guidance in this area and encourage other industries with network assets to request guidance under the IIR procedures.

The temporary regulations retain the definition of network assets provided in the 2008 proposed regulations and add an operative rule providing that in the case of network assets, the unit of property is determined by the taxpayer's particular facts and circumstances except as otherwise provided in guidance published in the **Federal Register** or the Internal Revenue Bulletin. The functional interdependence standard, by itself, could lead to unit of property definitions for network assets that are overly broad. Thus, functional interdependence is not determinative for network assets. Finally, the temporary regulations do not alter or invalidate previously published guidance addressing the treatment of network assets for particular industries, such as Rev. Proc. 2011–43 (2011–37 IRB 326) (safe harbor method for electric utility transmission and distribution property); Rev. Proc. 2011–28 (2011–18 IRB 743) (network asset maintenance allowance or units of property method for wireless telecommunication network assets); Rev. Proc. 2011–27 (2011–18 IRB 740) (network asset maintenance allowance or units of property method for wireline telecommunication network assets); Rev. Proc. 2002–65 (2002–2 CB 700) (track maintenance allowance method for Class II and III railroads); or Rev. Proc. 2001–46 (2001–2 CB 263) (track maintenance allowance method for Class I railroads).

c. Leased Property Other Than Leased Buildings

The IRS and the Treasury Department received several comments requesting that the proposed regulations include more detailed rules regarding the unit of property for leased personal property. The temporary regulations provide that a lessee's unit of property for leased real or personal property other than building property is determined under the general rules for property other than buildings, including the functional interdependence test and the plant property rule (as applicable), except that, after applying those applicable rules, the unit of property may not be larger than the unit of leased property.

4. Unit of Property for Improvements

The 2008 proposed regulations provided that an improvement to a unit of property, other than a leasehold improvement, is not a unit of property separate from the unit of property improved. The 2008 proposed regulations provided that a leasehold improvement made by a lessee that is section 1250 property is treated as a separate unit of property. The temporary regulations retain the general rule that an improvement is generally not a unit of property separate from the unit of property improved but clarify the rule for leasehold improvements. As explained below, the temporary regulations provide that only a ''lessee improvement,'' rather than a ''leasehold improvement,'' is a unit of property separate from the unit of property improved. Moreover, this rule has been moved to a separate subsection governing the unit of property for improvements.

5. Unit of Property for Leasehold Improvements

Current law provides that if a lessee makes a leasehold improvement that is not a substitute for rent, the lessee is generally required to capitalize the cost of the improvement under section 263(a) and §§ 1.162–11(b) and 1.167(a)–4 and, if the leasehold improvement is property to which section 168 applies, depreciate the improvement under section 168. *See* section 168(i)(8)(A). Current law, however, does not clearly address the unit of property for leasehold improvements.

The 2008 proposed regulations provided that, in the case of a leasehold improvement made by a lessee that is section 1250 property, the leasehold improvement is a separate unit of property. The 2008 proposed regulations did not address leased section 1245 property or discuss the unit of property for improvements made by a lessor. The IRS and the Treasury Department received several comments requesting that the regulations provide additional guidance on the unit of property for improvements to leased section 1250 property and address the unit of property for improvements to leased section 1245 property. In addition, commentators suggested that revised regulations provide operative rules for determining when there has been an improvement to leased property. In response to the comments, the temporary regulations address whether amounts paid by a lessee or lessor are for the improvement of a unit of leased property, requiring capital treatment. The temporary regulations also define the unit of property for purposes of determining whether amounts paid subsequent to an initial leasehold improvement must be capitalized.

The temporary regulations for lessee improvements are consistent with the rule in the 2008 proposed regulations but provide further elaboration and are extended to section 1245 property. The temporary regulations provide that an amount initially capitalized as a lessee improvement is treated as a cost of acquiring or producing a unit of property, and constitutes a unit of property separate from the leased property being improved. However, the cost of improving a lessee improvement is not a unit of property separate from the lessee improvement being improved.

Treating the lessee's initial improvement as a separate unit of property is based on the premise that, when making a leasehold improvement, the lessee should be treated as if it has acquired or produced new property. This new property interest is separate and distinguishable from the lessee's interest in the underlying property. Also, this approach is consistent with the depreciation rules under sections 168(i)(6) and (i)(8)(A), which treat the leasehold improvement as a separate asset for purposes of section 168. Finally, treatment of a lessee's subsequent improvement as part of the lessee's initial leasehold improvement is consistent with the rule governing the unit of property determination for improvements to owned property, which generally treats the improvement and the property improved as a single unit of property.

The temporary regulations also provide a rule for determining the unit of property for a lessor improvement. The temporary regulations provide that an amount capitalized as a lessor improvement is not a unit of property separate from the unit of property improved. This rule is based on the premise that the lessor of property generally should be treated in the same manner as any other owner of property when it makes an improvement to its property. Thus, in accordance with the general rule for property owners, a lessor improvement to a unit of property is not a unit of property separate from the property being improved.

6. Additional Rules for Determining Units of Property

The 2008 proposed regulations included two additional rules that, if applicable, would more narrowly define the unit of property for property other than buildings. The 2008 proposed regulations provided that a component must be treated as a separate unit of property if, at the time the unit of property is placed in service by the taxpayer, the taxpayer has recorded on its books and records for financial or regulatory accounting purposes an economic useful life for the component that is different from the economic useful life of the unit of property of which the component is a part (the ''book life consistency rule''). The 2008 proposed regulations also provided that a component must be treated as a separate unit of property if the taxpayer has properly treated the component as being within a different MACRS class than the class of the unit of property of which the component is a part, or depreciated the component using a section 167 or section 168 depreciation method different from the depreciation method for the unit property of which the component is a part (the ''depreciation consistency rule'').

The IRS and the Treasury Department received several comments requesting that the book life consistency rule be removed from the final regulation. Commentators noted that tax and financial accounting have different goals and that a taxpayer generally has non-tax reasons for classifying property differently for financial accounting purposes. For these reasons, the temporary regulations do not adopt the book life consistency rule contained in the 2008 proposed regulations.

The temporary regulations retain the depreciation consistency rule that applies to property, other than buildings, in the taxable year the property is initially placed in service. The temporary regulations add a second depreciation consistency rule that applies if a taxpayer or the IRS properly changes the MACRS class or depreciation method for any type of property (for example, as a result of a cost segregation study or a change in the use of the property) in a taxable year after the year the property was initially placed in service. Under this rule, the taxpayer must change the unit of property determination for the effected property to be consistent with the change in treatment for depreciation purposes. Thus, for example, if a taxpayer performs a cost segregation study and changes the classification of components in a building from section 1250 property to section 1245 property, the taxpayer must use the same classifications to define the unit of property for capitalization purposes.

C. Special Rules for Improvements

1. Improvements to Leased Property

The 2008 proposed regulations provided that a taxpayer must capitalize amounts paid to acquire or produce a unit of real or personal property, including leasehold improvement property. The 2008 proposed regulations also noted that a taxpayer must capitalize amounts paid to improve a unit of property whether the taxpayer is the owner or lessee of the unit of property. However, the 2008 proposed regulations did not provide operative rules for determining whether there was an improvement to leased property (''leasehold improvement'') and did not clarify how a leasehold improvement must be treated under the regulations.

a. Application of Intangible Regulation Under § 1.263(a)–4 to Leasehold Improvements

The IRS and the Treasury Department received several informal questions and comments regarding whether lessee improvements should be capitalized under the 2008 proposed regulations or under § 1.263(a)–4 (''intangibles regulations''), which governs the capitalization of costs related to intangible property. Section 1.263(a)–4(d)(8), which is titled ''Certain benefits arising from the provision, production, or improvement of real property,'' provides, in part, that a taxpayer must capitalize amounts paid to produce or improve real property owned by another if the real property can reasonably be expected to produce significant economic benefits for the taxpayer. Examples of amounts capitalized under this section include amounts contributed by a taxpayer to a city to defray the cost of constructing a publicly owned bridge capable of accommodating the taxpayer's trucks and amounts contributed by a taxpayer to a port authority to build a breakwater that will make it easier for the taxpayer to unload its vessels.

Section 1.263(a)–4(d)(8) of the regulations was not intended to apply to leasehold improvements or to situations in which the taxpayer pays to acquire or produce tangible property that clearly benefits the taxpayer and not other parties. The examples provided under the intangibles regulations involve improvements to public assets where there is an intangible economic benefit to the taxpayer, not a direct tangible interest in property, such as a leasehold interest. In contrast to the examples under the intangibles regulations, a leasehold improvement involves an interest in tangible property for which basis recovery is permitted through depreciation. *See,* for example, section 168(i)(8)(A) (treatment of leasehold improvements that are subject to section 168).

The temporary regulations provide that § 1.263(a)–4 does not apply to amounts paid for improvements to units of leased property or to amounts paid for the acquisition or production of leasehold improvement property. In addition, the temporary regulations provide operative rules for the definition and treatment of leasehold improvements by lessees and lessors and clarify that these rules are the exclusive guidance for determining whether amounts paid by a taxpayer are for an improvement to a unit of leased property.

b. Operative Rules for Leasehold Improvements

The IRS and the Treasury Department received several comments requesting that the regulations provide guidance regarding the application of the improvement rules to leased section 1250 property (generally real property) and leased section 1245 property (generally personal property). The temporary regulations apply to both leased real property and leased personal property and provide operative rules for both lessees and lessors that make improvements to a leased unit of property.

i. Lessee Improvements

Under the temporary regulations, a taxpayer lessee must capitalize the aggregate of related amounts that it pays to improve a unit of leased property, except to the extent that section 110 applies to a construction allowance received by the lessee for the purpose of such improvement or where the improvement constitutes a substitute for rent. A taxpayer lessee must also capitalize the aggregate of related amounts paid by the lessor to improve a unit of leased property if the lessee owns the improvement for federal income tax purposes, except to the extent that section 110 applies to a construction allowance received by the lessee for the purpose of such improvement. An amount paid for a lessee improvement under the temporary regulations is treated as an amount paid to acquire or produce a unit of real or personal property under § 1.263(a)–2T(d)(1)(i).

Because a lessee improvement involves the acquisition or production of a new and distinct interest in property and this property interest is often different from the underlying leased property, amounts paid for a lessee improvement are treated as the acquisition or production of a new unit of property (that is, a unit of property separate from the leased unit of property), rather than an improvement to the underlying property. This treatment is consistent with the depreciation requirements under section 168(i)(8)(A), which do not allow a taxpayer to depreciate leasehold improvements over the term of the underlying lease, but rather require that a taxpayer depreciate the leasehold improvement over the applicable recovery period under MACRS for the type of property acquired or produced.

ii. Lessor Improvements

The temporary regulations provide that a taxpayer lessor must capitalize the aggregate of related amounts that it pays directly, or indirectly through a construction allowance to the lessee, to improve a unit of leased property where the lessor is the owner of the improvement or to the extent that section 110 applies to the construction allowance. In addition, a lessor must also capitalize the aggregate of related amounts paid by the lessee to improve a unit of leased property where the lessee's improvement constitutes a substitute for rent. Finally, amounts capitalized by the lessor under this paragraph may not be capitalized by the lessee.

The rules provided in the temporary regulations for lessor improvements are corollaries to the rules provided for lessee improvements. In general, a lessor must capitalize amounts paid for leasehold improvements where the lessor is the owner of the leasehold improvement, where section 110 applies, or where the lessee's improvement is a substitute for rent. However, in contrast with a lessee, the lessor is the owner of the underlying property. As such, a lessor improvement is treated in the same manner as any other owner improvement to a unit of property. Therefore, a lessor improvement is treated as an improvement to the underlying property under § 1.263(a)–3T and is not treated as the acquisition or production of a new unit of property.

2. Certain Costs Incurred During an Improvement

The 2008 proposed regulations did not prescribe a plan of rehabilitation doctrine as traditionally described in the case law. That judicially-created doctrine provides that a taxpayer must capitalize otherwise deductible repair or maintenance costs if they are incurred as part of a general plan of rehabilitation, modernization, and improvement to the property. *See Moss* v. *Commissioner,* 831 F.2d 833 (9th Cir. 1987); *United States* v. *Wehrli,* 400 F.2d 686 (10th Cir. 1968); *Norwest Corp.* v. *Commissioner,* 108 T.C. 265 (1997). Instead, the 2008 proposed regulations incorporated the section 263A rules for the treatment of repairs and maintenance performed during an improvement. Specifically, the 2008 proposed regulations provided that a taxpayer must capitalize all the direct costs of an improvement and all the indirect costs (including otherwise deductible repair costs) that directly benefit or are incurred by reason of an improvement in accordance with the rules under section 263A. *See* § 1.263A–1(e). Thus, the 2008 proposed regulations concluded that repairs and maintenance that do not directly benefit and that are not incurred by reason of an improvement are not required to be capitalized under section 263(a), regardless of whether the repairs and maintenance are performed at the same time as an improvement. The 2008 proposed regulations also included an exception for an individual residence, which permitted an individual taxpayer to capitalize repair and maintenance costs incurred at the time of a substantial remodel of its residence.

The temporary regulations retain the general rule from the 2008 proposed regulations for otherwise deductible indirect costs incurred during an improvement but clarify that all indirect costs, including repair and removal costs, are subject to the section 263A standard. The temporary regulations also retain the exception for substantial improvements to individual residences.

The rules provided in section 263A and § 1.263A–1(e) regarding the capitalization of indirect costs require the capitalization of indirect costs that directly benefit or are incurred by reason of an improvement to property. By adopting the § 1.263A–1(e) standard for purposes of section 263(a), the temporary regulations set out a clearly articulated standard that provides appropriate parameters for determining when otherwise deductible indirect costs must be capitalized as part of an improvement to property. Accordingly, the temporary regulations obsolete the plan of rehabilitation doctrine to the extent the court created doctrine provided different standards for determining whether an otherwise deductible indirect cost must be capitalized as part of an improvement.

3. Removal Costs

The 2008 proposed regulations did not address the treatment of amounts paid to remove a unit of property, asset, or a component of a unit of property. Examples in the 2008 proposed regulations, however, suggested that if a taxpayer removes a component in order to facilitate a replacement and the costs of the replacement component constitute an improvement to the unit of property, then the costs of removing the old component must be treated a part of the improvement.

No comments were received addressing the treatment of removal costs, and the temporary regulations do not include a specific rule for such costs. But the costs of removing a component of a unit of property should be analyzed in the same manner as any other indirect cost incurred during an improvement to property. Thus, similar to the treatment of otherwise deductible repair and maintenance costs incurred during an improvement, the costs of removing a component of a unit of property must be capitalized if they directly benefit or are incurred by reason of an improvement to a unit of property. *See,* for example, *Towanda Coke Corp.* v. *Commissioner,* 95 T.C. 124 (1990) (holding that costs of removing piping damaged in a fire and installing new pipe were capital expenditures); *Phillips Easton Supply Co.* v. *Commissioner,* 20 T.C. 455 (1953) (holding that costs of removing a cement floor in a building and replacing it with a concrete floor were capital expenditures to improve the property); Rev. Rul. 2000–7 (2000–1 CB 712) (providing that the costs of removing a component of a depreciable asset are either capitalized or deducted based on whether the replacement of the component constitutes an improvement or a repair). As with other costs incurred during an improvement, a taxpayer may deduct the costs of removing a component if the taxpayer can demonstrate that such costs relate only to the disposition of the removed property and that the costs do not have the requisite relationship to any improvement.

In addition, the temporary regulations do not affect the holding of Rev. Rul. 2000–7 as it applies to the costs of removing an entire unit of property. Under Rev. Rul. 2000–7, a taxpayer is not required to capitalize the cost of removing a retired depreciable asset under section 263(a) or section 263A, even where the retirement and removal occurred in connection with the installation of a replacement asset. Historically, the costs of removing a depreciable asset generally have been allocable to the removed asset and, thus, generally have been deductible when the asset is retired. *See* § 1.165–3(b); § 1.167(a)–1(c); § 1.167(a)–11(d)(3)(x); Rev. Rul. 74–455 (1974–2 CB 63); Rev. Rul. 75–150 (1975–1 CB 73). Because the costs of removing a retired asset typically relate to the depreciable asset being removed and are not allocable to the improvements, § 1.263(a)–3T generally is not applicable to such removal costs. Moreover, the temporary regulations do not change the treatment of any amounts addressed under section 280B, which governs amounts expended and losses sustained for the demolition of structures.

D. Safe Harbor for Routine Maintenance

The 2008 proposed regulations provided a safe harbor from capitalization for the costs of performing certain routine maintenance activities. Under the safe harbor, an amount paid was deemed not to improve the unit of property if it was for the ongoing activities that a taxpayer (or a lessor) expected to perform as a result of the taxpayer's (or the lessee's) use of the unit of property to keep the unit of property in its ordinarily efficient operating condition. The activities were routine only if, at the time the unit of property was placed in service, the taxpayer reasonably expected to perform the activities more than once during the class life of the unit of property (that is, the recovery period prescribed under sections 168(g)(2) and 168(g)(3), regardless of whether the property was depreciated under section 168(g)).

The IRS and the Treasury Department received comments criticizing the safe harbor's use of defined class life as the testing period. Instead, the comments suggested that the safe harbor should utilize the economic useful life of the unit of property as the appropriate testing period. The temporary regulations retain the requirement that a taxpayer must expect to perform routine maintenance more than once during the defined class life of the unit of property. The class life based standard is more objective, is more consistent among taxpayers, and is more administrable than a standard based on the economic useful life of the property. Notably, during the consideration of the 2006 proposed regulations, many commentators expressed concern that the economic useful life of property is not an accurate determinant of its actual useful life and that reliance on this standard would create disparate treatment among taxpayers in characterizing similar costs.

The IRS and the Treasury Department also received comments regarding the application of the routine maintenance safe harbor to buildings. Because buildings typically have a long class life (for example, 39.5 years for nonresidential real property), many remodeling projects arguably could be deducted under the safe harbor, regardless of the nature or extent of the work involved. For example, if a taxpayer expected to replace a major component, such as a roof, an HVAC system, or an electrical system, more than once during the long class life of the building, then the costs of such replacements generally would have been deductible under the safe harbor. Allowing a deduction for costs attributable to these types of projects is inconsistent with much of the case law addressing building improvements. Generally, the courts have held that amounts paid for replacements of major components or substantial structural parts of buildings and their structural components are capital expenditures. *See,* for example, *Tsakopoulous* v. *Commissioner,* T.C. Memo 2002–8 (holding that costs to replace the roof on a portion of the suites of a shopping center were capital expenditures); *Hill* v. *Commissioner,* T.C. Memo 1983–112 (holding that costs to replace the water heater and the furnace in rental property were capital expenditures); *Stewart Supply Co.* v. *Commissioner,* T.C. Memo 1963–62 (holding that costs to replace the front wall of a building and make electrical connections to that wall were capital expenditures); *First Nat'l Bank* v. *Commissioner,* 30 B.T.A. 632 (1934) (holding that costs of replacing the electrical system in a bank building were capital expenditures); *Georgia Car and Locomotive Co.,* 2 B.T.A. 986 (1925) (holding that costs of a new roof on a building were capital expenditures).

Accordingly, the routine maintenance safe harbor is not appropriate for work performed on buildings. Rather, the proper analysis requires the application of the general rules for improvements, including the rules for determining whether the costs are incurred for a betterment or restoration to the building or the building systems, or to adapt the building or any of its systems to a new or different use. The temporary regulations revise the routine maintenance safe harbor to apply only to property other than buildings. In addition, the temporary regulations include new rules clarifying the application of the improvement standards to a building and provide new examples illustrating the application of these rules.

E. Betterments

The 2008 proposed regulations provided that an amount paid results in a betterment, and accordingly, an improvement, if it ameliorates a material condition or material defect that existed prior to the acquisition of the property or arose during the production of the property; results in a material addition to the unit of property (including a physical enlargement, expansion, or extension); or results in a material increase in the capacity, productivity, efficiency, strength, or quality of the unit of property or its output. The temporary regulations retain all of these criteria, as well as the 2008 proposed rules that detail how the betterment standards are applied.

The IRS and the Treasury Department received several comment letters recommending that the drafters modify the betterment rules in several areas, create exceptions for particular situations, and clarify or modify some of the examples. One commentator expressed concern that the 2008 proposed regulations' definition of betterments would require a taxpayer to capitalize costs that do not extend the useful life of the unit of property as a whole and suggested that the MACRS rules be modified so that betterments would be assigned a recovery period based on the remaining recovery period of the unit of property. Such a revision to the MACRS regulations would be contrary to section 168(i)(6), which generally requires that the depreciation deduction for an addition or improvement be computed in the same manner as the depreciation deduction for the underlying property would be computed if the underlying property had been placed in service at the same time as the addition or improvement.

1. Amounts Paid to Ameliorate Material Conditions and Defects

a. Knowledge of Defect

Several commentators suggested changes to the 2008 proposed rule that defined a betterment as an amount paid to ameliorate a material condition or defect that existed prior to acquisition or arose during the production of the unit of property, whether or not the taxpayer was aware of the defect at the time of acquisition or production. One commentator suggested that a taxpayer should be required to capitalize the costs of ameliorating a defect only if the taxpayer was aware of or should have been aware of the defect at the time of acquisition. Another commentator suggested that a taxpayer should be required to capitalize these costs only if they were incurred within two years of the acquisition of the property.

The temporary regulations do not revise the rule to require that a taxpayer's knowledge be taken into account in determining whether expenditures to ameliorate a preexisting condition or defect must be capitalized. The rule provided in the 2008 proposed regulations is consistent with established case law, which requires a taxpayer to capitalize these costs whether or not the taxpayer was aware of the defect at the time of acquisition. *See United Dairy Farmers, Inc.* v. *United States,* 267 F.3d 510 (6th Cir. 2001); *Dominion Resources, Inc.* v. *United States,* 219 F.3d 359 (4th Cir. 2000); *La France Wine Co.* v. *Commissioner,* T.C. Memo 1974–254. In addition, a rule that would require a subjective inquiry as to the taxpayer's knowledge at the time of acquisition or production would be difficult for the IRS to administer and to enforce.

Finally, the IRS and the Treasury Department did not adopt the suggestion to add a two-year limitation on the application of the rule because such a limitation might encourage a taxpayer simply to postpone its expenditures to avoid treatment as an improvement.

b. Environmental Cleanup of Reacquired Property

As mentioned above, the 2008 proposed regulations required a taxpayer to capitalize an amount paid to ameliorate a material condition or defect that existed at the time the taxpayer acquired or produced the property. The rule follows the general principle that a taxpayer must capitalize costs incurred to correct a pre-existing defect in acquired property regardless of whether the taxpayer was aware of the defect at the time of acquisition. *See United Dairy Farmers, Inc.* v. *United States,* 267 F.3d 510 (6th Cir. 2001). The preamble to the 2008 proposed regulations stated that under this rule a taxpayer would be required to capitalize environmental remediation costs in the situation in which the taxpayer contaminated property in the course of its business operations, disposed of the property (for example, by sale), and later reacquired property to clean up the contamination. The preamble requested comments regarding the appropriate treatment of environmental remediation costs in these situations, including how to determine whether the taxpayer's own use, or a prior owner's use, caused the contamination.

Several commentators recommended that the regulations allow a deduction for clean-up costs under certain circumstances after a taxpayer acquires, or reacquires, property that the taxpayer had previously contaminated. The commentators generally asserted that a taxpayer that acquires or reacquires property that it had previously contaminated should be treated no differently than a taxpayer that continuously owns the property and contaminated the property through the course of its operations. See Rev. Rul. 94–38 (1994–1 CB 35), in which a taxpayer was permitted to deduct the costs of remediating property that it continuously owned and contaminated in the course of its operations because the taxpayer restored the property to the condition it was in prior to the circumstances necessitating the expenditure. One commentator addressed the situation in which a taxpayer contaminates property as a lessee of property and later acquires the property in an effort to minimize disputes with the lessor over clean-up obligations. The commentator recommended an exception to capitalization for amounts incurred to clean up contamination that existed at the time a taxpayer acquires property provided (1) the taxpayer is legally liable for the cost of cleaning up the property prior to its acquisition by the taxpayer, and (2) the taxpayer's sole purpose for acquiring the property is to minimize the cost of clean-up. The commentator also indicated that a taxpayer that acquires contaminated property for an amount that is at least equal to the remediated fair market value of the property should be treated no differently than a taxpayer that continuously owned the property.

The IRS and the Treasury Department recognize that a taxpayer that acquires, or reacquires, contaminated property for an amount at least equal to the remediated fair market value of the property may be in a position similar to that of a taxpayer that had continuously owned the property. However, the IRS and the Treasury Department are reluctant to create a rule that would hinge on the taxpayer's purpose for acquiring the property and a subjective determination of the remediated fair market value of the property. Moreover, Congress specifically provides a deduction under section 198 for taxpayers that incur certain environmental remediation expenditures that are otherwise required to be capitalized under section 263(a), including costs incurred by taxpayers conducting remediation on reacquired property. Taxpayers that elect to deduct these remediation costs under section 198 must comply with the requirements of that provision.

The IRS and the Treasury Department recognize, however, that a taxpayer may encounter an unusual situation for which section 198 does not provide relief or to which the rationale underlying the temporary regulations does not apply. The IRS and the Treasury Department believe that these situations are better addressed through subject-specific guidance outside the regulations. Any taxpayer with a specific concern regarding the treatment of these types of costs should consider submitting a request for a private letter ruling under Rev. Proc. 2011–1 (2011–1 IRB 1) (or its successor).

2. Material Increase in Capacity, Productivity, Efficiency, Strength, or Quality

The 2008 proposed regulations defined betterments to include expenditures that result in a material increase in the capacity, productivity, efficiency, strength, or quality of the unit of property or its output. One commentator expressed concern about the subjective nature of determining any increase in ''quality'' of a unit of property. The temporary regulations do not change this standard but revise the examples from the 2008 proposed regulations and add a number of new examples to help illustrate and clarify the application of the increase in quality standard to particular facts and circumstances.

Another commentator requested an example that permitted a deduction for the costs of earthquake retrofitting. The temporary regulations do not include an example allowing a deduction for earthquake retrofitting. Earthquake retrofitting encompasses various factual scenarios and could involve substantial structural additions that strengthen the unit of property and that may constitute betterments under the temporary regulations. Also, the temporary regulations retain an example from the 2008 proposed regulations that illustrates that certain amounts paid to strengthen a building to make it safer in the event of an earthquake may constitute a betterment to the unit of property. The temporary regulations illustrate that a taxpayer's treatment of amounts paid for earthquake retrofitting depends on the taxpayer's particular facts and circumstances.

3. Refreshing and Remodeling Buildings

The 2008 proposed regulations provided an example that addressed whether amounts paid to update or remodel a building resulted in a betterment because they materially increased the capacity, productivity, efficiency, strength, or quality of the unit of property. In *Example 6* of § 1.263(a)–3(f)(3) of the 2008 proposed regulations, a taxpayer was not required to capitalize as betterments the amounts paid to change periodically the layout and appearance of its retail stores. The IRS and the Treasury Department received several comments suggesting that additional examples be added to the regulations to clarify the types of refresh or remodel expenses that would not result in a betterment. One commentator suggested the addition of an example illustrating that a remodel expense intended to increase sales should not, by itself, be evidence of a material increase in the quality of the unit of property under the betterment standards. Another commentator recommended revising the betterment standards to clarify that minor costs incurred as part of regularly recurring store updates are treated as currently deductible selling or marketing expenses.

The betterment standards in the temporary regulations have not been revised to create an exception for minor and recurring store refresh or remodel costs. The analysis of whether store refresh or remodel costs result in a betterment requires an examination of all the facts and circumstances. The application of a per se exception to capitalization for all costs incurred as part of a recurring store refresh or remodel would be inappropriate, for example, in situations where a taxpayer performs major structural work on the building during a refresh or remodel.

To provide additional guidance in this area, however, the temporary regulations expand upon the facts and analysis provided in *Example 6* and set out additional examples addressing the refreshing and remodeling of retail buildings. The additional examples demonstrate a range of outcomes based on the amount and type of work performed on the building and its structural components. The examples in the temporary regulations illustrate a refresh of retail buildings that merely keeps the buildings in ordinarily efficient operating condition; a refresh of retail buildings that also includes an improvement to a building system; and finally, a large scale refresh and remodel of retail buildings that involve an improvement to the buildings. These examples also illustrate the application of the rule governing the treatment of indirect costs incurred during an improvement of property.

F. Restorations

The 2008 proposed regulations provided that an amount is paid to restore, and therefore improve, a unit of property if it (1) is for the replacement of a component of a unit of property and the taxpayer has properly deducted a loss for that component (other than a casualty loss under § 1.165–7); (2) is for the replacement of a component of a unit of property and the taxpayer had properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component; (3) is for the repair of damage to a unit of property for which the taxpayer has properly taken a basis adjustment as a result of a casualty loss under section 165, or relating to a casualty event described in section 165; (4) returns the unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and was no longer functional for its intended use; (5) results in the rebuilding of the unit of property to a like-new condition after the end of its economic useful life; or (6) is for the replacement of a major component or a substantial structural part of the unit of property.

The IRS and the Treasury Department received many comments regarding the 2008 proposed restoration rules. The temporary regulations generally retain the restoration standards set forth in the 2008 proposed regulations but have revised certain definitions as well as the operation and the application of some of the rules. The comments, the revisions, and the reasons for these changes are discussed below.

1. Casualty Loss

The 2008 proposed regulations provided that an amount is paid to restore a unit of property if it is for the repair of damage to the unit of property for which the taxpayer had properly taken a basis adjustment as a result of a casualty loss under section 165, or relating to a casualty event described in section 165 (''casualty loss rule''). The IRS and the Treasury Department received comments from several practitioners and industry groups requesting that the drafters remove the proposed casualty loss rule from the regulation. These commentators requested that the regulations confirm and acknowledge that a taxpayer that is engaged in a trade or business is entitled to claim a casualty loss deduction, adjust basis in the property, and claim an ordinary and necessary business expense deduction to repair the property damaged in the casualty event.

The temporary regulations retain the casualty loss rule because the rule is consistent with the fundamental principle that a taxpayer must capitalize the cost of acquiring new property. The casualty loss rule is also consistent with the restoration rules in the temporary regulations that require a taxpayer to capitalize the cost of a replacement component where it has properly deducted a loss for the component or taken into account the adjusted basis of the component in realizing gain or loss. In these situations, a taxpayer deducts the amount of the loss, reduces basis in the unit of property by the amount of loss, and then incurs costs to acquire a replacement component. Thus, the replacement is treated like the acquisition of new property (that is, the replacement of the reduced or eliminated basis), and the amounts paid for the replacement is treated as a capital expenditure. The replacement of property damaged in a casualty may involve the replacement or restoration of the entire property or components of that property. In either event, the damaged part of the property is treated as retired, the basis attributable to the damaged part is removed, and the damaged part is restored or replaced. Thus, costs to restore or replace the portion of property for which basis has been recovered are analogous to the costs of acquiring new property and must be treated as capital expenditures.

In response to the casualty loss rule in the 2008 proposed regulations, commentators contended that the casualty loss and the repair expense do not create a double deduction for the same item because they arise out of separate tax events. Specifically, the commentators argued that the casualty loss permitted under section 165(c) compensates the taxpayer for the unanticipated diminution in value of the taxpayer's property, while the repair expense deduction permitted under section 162 compensates the taxpayer for its out-of-pocket expenditures necessary to restore its property to working condition. The commentators emphasized that sections 165 and 162 confer separate benefits with separate regulatory requirements.

The IRS and the Treasury Department recognize that the section 165 loss and the section 162 business expense deduction do not create a double deduction for the same item and do confer different benefits to a taxpayer engaged in a trade or business. The section 165 loss permits recognition for a property loss suffered (in this case due to a casualty), and the section 162 deduction allows a taxpayer to take current deductions for the ordinary and necessary expenses of carrying on a trade or business, unless such deductions are prohibited under section 263(a). Where a casualty event occurs, however, the application of the section 165 loss provisions to a unit of property, specifically the reduction of basis that is required, creates a situation where the principles of section 263(a) should apply to the restoration event to prohibit a section 162 deduction. As discussed, in this situation, the amounts paid to restore property are analogous to the costs of acquiring new property and are properly capitalized, in this case through the addition of basis to the restored underlying property.

Commentators also asserted that the casualty loss rule in the 2008 proposed regulations negated the benefit of the casualty loss deduction specifically permitted under section 165(c) and § 1.165–7(a)(1) to a taxpayer engaged in a trade or business where there is partial damage to property, rather than full destruction. The commentators claimed that the casualty loss rule results in especially harsh treatment to a business taxpayer because this taxpayer must capitalize its restoration costs and recover them over the full recovery period assigned to the underlying property starting in the year the improvement is placed in service.

By retaining the casualty loss rule, however, the temporary regulations are not eliminating the benefit provided to trade and businesses by the allowance of a casualty loss. Rather, the temporary regulations are disallowing the acceleration of deductions for both the casualty loss and the costs of restoring the property. The casualty loss rule does not limit a taxpayer's ability to accelerate the recovery of the basis attributable to such property through the section 165 loss provisions. Rather, it requires a taxpayer to capitalize the costs of restoring the property, with recovery of such costs permitted through depreciation over the proper recovery period.

One commentator asserted that it was Congress' intent in enacting section 165(c) and the Treasury Department's intent in applying section 165(c) to business taxpayers (which, the commentator contends, is imputed to Congress through legislative enactment) to confer a benefit on all taxpayers by allowing them a casualty loss in situations where such loss would not otherwise be deductible (that is, where there is only partial damage to the property). The commentator further explains that a requirement to capitalize otherwise deductible section 162 expenses following a casualty undercuts Congress' intent in allowing a current deduction for the loss in value of the property. The problem with this analysis, however, is that an individual not engaged in a trade or business or in a for-profit transaction (an individual) is not entitled to an additional deduction under section 162 or any other provision for amounts paid to repair the damaged property. Thus, Congress could not have intended to provide an additional benefit to all taxpayers (in the form of a section 162 deduction) through legislative reenactment, where that benefit was not available to an individual who had suffered partial damage from a casualty. In general, an individual takes the loss deduction, reduces its basis in the damaged property, and capitalizes the costs of restoring the damaged property. In contrast, under the commentator's preferred approach, a business taxpayer would take the loss deduction, reduce the basis of the damaged property, and then claim an immediate deduction for the restoration costs. Thus, the commentator's approach would result in disparate results between individual and business taxpayers.

The casualty loss rule is consistent with current law. Although commentators pointed to cases that specifically permit taxpayers to take business expense deductions for the costs of restoring property damaged in a casualty event, those same cases often imply that a repair expense and a loss deduction are of opposite character and may be mutually exclusive. *See,* for example, *Trinity Meadows Raceway* v. *Commissioner,* 187 F.3d 638 (6th Cir. 1999) (unpublished decision) (disallowing both a casualty loss and a related section 162 deduction for property damaged by a flood because the taxpayer did not maintain adequate records but stating that a taxpayer may deduct the repairs under section 162 or take the loss in value under section 165); *Hubinger* v. *Commissioner,* 36 F.2d 724 (2nd Cir. 1929) (holding taxpayer could not deduct the costs of reconditioning property after a fire as ordinary and necessary expenses because such items were more in the nature of casualty losses, but taxpayer was not entitled to casualty loss because there was no proof of loss); *R. R. Hensler, Inc.* v. *Commissioner,* 73 T.C. 168 (1979), *acq.,* (1980–2 CB 1) (allowing a business expense deduction for taxpayer's cost of recovering, repairing, and replacing equipment ''displaced and damaged'' by flood and distinguishing such property from property that is ''lost, destroyed, or abandoned'' and which ''gives rise to a loss under section 165''); *Atlantic Greyhound Corp.* v. *United States,* 111 F. Supp. 953 (Ct. Cl. 1953) (disallowing casualty losses for the expenses of repairing buses occasioned by accidents because such damage was ''expected, normal, and inevitable'' and the costs of repairing such damage was ordinary and necessary). In addition, where this question has been raised, the courts have not opined on whether the taxpayer may take a casualty loss and a business expense deduction with regard to a single casualty. *See R.R. Hensler,* 73 T.C. at 176 n. 9; *Louisville & Nashville R.R. Co.* v. *Commissioner,* T.C. Memo 1987–616, n. 24.

The IRS and the Treasury Department are aware that the property damaged in a casualty event might have remaining basis that is insignificant compared to the costs necessary to restore the property. Focusing on this possibility, commentators requested that if the casualty loss rule contained in the 2008 proposed regulations were retained, consideration should be given to allowing taxpayers to forgo claiming a section 165 loss in order to qualify for a section 162 deduction. The temporary regulations address this concern and provide for such a result. Specifically, the temporary regulations revise the rules of accounting for property to which section 168 applies (MACRS property) and also for determining gain or loss upon the disposition of MACRS property. These rules, discussed in more detail in section VII of this preamble, provide that a taxpayer electing to use a general asset account under temporary regulation § 1.168(i)–1T may forgo recognizing a casualty loss (without reducing basis) and may claim a repair deduction under section 162 for the replacement property, provided the replacement cost is not treated as a capital expenditure under a different provision of the temporary regulations.

2. Rebuilding to Like-New Condition

The 2008 proposed regulations provided that if an amount paid results in the rebuilding of a unit of property to a like-new condition after the end of its economic useful life, the amount must be capitalized as a restoration of the unit of property. However, an exception provided that if the amount is paid after the economic useful life of the property but during the recovery period (as prescribed in section 168(c)), the amount is not required to be capitalized. The temporary regulations revise the rule to apply only to amounts paid to rebuild the unit of property after the end of the class life of the unit of property as defined under sections 168(g)(2) and (3). The temporary regulations also remove the recovery period exception so that a taxpayer must look only to the class life of the property in determining the application of this rule. The use of defined class life rather than economic useful life provides a more objective standard for determining whether the rebuilding rule applies and is consistent with the standard that applies in determining whether amounts qualify for the routine maintenance safe harbor. This more objective standard is designed to avoid disputes that might otherwise arise in determining the economic useful life of property and to provide for consistent application among taxpayers that hold the same type of property.

3. Replacement of Major Component or Substantial Structural Part

The 2008 proposed regulations provided that an amount paid for the replacement of a major component or a substantial structural part of a unit of property is an amount paid to restore (and therefore improve) the unit of property. The 2008 proposed regulations defined ''major component or substantial structural part'' as a part or a combination of parts of the unit of property, the cost of which comprises 50 percent or more of the replacement cost of the unit of property or the replacement of which comprises 50 percent or more of the physical structure of the unit of property (''the 50 percent thresholds''). Furthermore, the 2008 proposed regulations provided that an amount was not required to be capitalized as a replacement of a major component or substantial structural part if it was paid during the recovery period prescribed in section 168(c) (''recovery period limitation'').

The IRS and the Treasury Department received two comments on this provision. One commentator suggested that the regulation should provide guidance establishing reasonable methods for substantiating replacement costs. This commentator also recommended that the drafters eliminate the 50 percent thresholds because physical structure is too difficult to measure. Another commentator suggested that the 50 percent thresholds should be abandoned arguing that they have no basis in law and will lead to unexpected complications in application.

The 50 percent thresholds and the recovery period limitation were first introduced in the 2008 proposed regulations. The exceptions were intended to provide a more objective standard for capitalization in this area and to counter the effect of the disposition and depreciation rules for buildings that generally require a taxpayer to capitalize and depreciate multiple replacements of the same structural component while continuing to recover the cost of the original structural component as part of the asset (for example, a taxpayer could not take a retirement loss on the disposition of a structural component of a building).

The 50 percent thresholds and the recovery period limitation in the 2008 proposed regulations provided an objective, bright-line alternative to the highly factual analysis applied by the courts and the IRS in determining whether a replacement part is a major component or substantial structural part of property and must therefore be capitalized, or is a relatively minor portion of the physical structure of the property or of any of its major parts and may therefore be deducted as a repair. Neither the courts nor the IRS, however, have previously adopted or applied the 50 percent thresholds or the recovery period limitation in determining whether a taxpayer must capitalize the cost of replacement parts or components. *See,* for example, *Buckland* v. *United States,* 66 F. Supp. 681 (D. Conn. 1946) (holding that costs to replace window sills in a factory building were deductible); Rev. Rul. 2001–4, 2001–1 CB 295 (holding, in part, that costs of certain heavy maintenance on aircraft airframe were deductible); *Smith* v. *Commissioner,* 300 F.3d 1023, 1032 (9th Cir. 2002) (holding that costs of relining aluminum smelting cells were capital expenditures even though they amounted to only 22.21 percent of the costs of replacing an entire cell); *Denver & Rio Grande Western R.R. Co.* v. *Commissioner,* 279 F.2d 368 (10th Cir. 1960) (holding that costs to replace the floor planks and stringers of a viaduct were capital expenditures); *P. Dougherty Co.* v. *Commissioner,* 159 F.2d 272 (4th Cir. 1946) (holding that costs of replacing the stern section of a barge were capital expenditures); *Tsakopoulous* v. *Commissioner,* T.C. Memo 2002–8 (holding that costs to replace the roof on a portion of the suites of a shopping center were capital expenditures); *Stewart Supply Co.* v. *Commissioner,* T.C. Memo 1963–62 (holding that costs to replace a front wall of a building and make electrical connections to that wall were capital expenditures).

The IRS and the Treasury Department are concerned that the 50 percent thresholds and the recovery period limitation, although objective, will lead to results that are drastically different from the results reached in the case law and rulings in this area. The 50 percent thresholds and the recovery period limitation would, in many cases, allow the replacement of a major component or substantial structural part to be treated as deductible repair rather than a capital expenditure, in effect reversing most of the existing authorities.

The temporary regulations therefore retain the standard that requires capitalization of an amount paid for the replacement of a major component or substantial structural part of the unit of property but revise the standard to more closely follow the facts and circumstances approach used by the courts. Under the temporary regulations, in determining whether an amount is paid for the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of the unit of property, the taxpayer must consider all the facts and circumstances, including the quantitative or qualitative significance of the part or combination of parts in relation to the unit of property or, in the case of a building, in relation to the building structure or the relevant building system. The temporary regulations also define a major component or substantial structural part to include a part or combination of parts that comprise a large portion of the physical structure of the unit of property or that perform a discrete and critical function in the operation of the unit of property. The replacement of a minor component of the unit of property, even though such component may affect the function of the unit of property, will not generally by itself constitute a major component or substantial structural part under the temporary regulations. The temporary regulations add a number of examples to illustrate the application of the revised standards in a variety of situations, including its application to a building structure and building systems.

In addition, the temporary regulations revise the disposition and depreciation rules to minimize the harsh result that occurs when an original part and any subsequent replacements of the same part are required to be capitalized and recovered simultaneously. As mentioned, in the case of buildings, taxpayers are currently required to capitalize and depreciate the costs to replace a structural component and to continue to recover the cost of the original structural component (for example, a taxpayer could not take a retirement loss on the disposition of a structural component of a building). For example, if a taxpayer were required to capitalize the costs of replacing an entire roof, it could not recover its basis in the original roof that was removed. Rather, the taxpayer would have to continue depreciating the removed roof, and at the same time, capitalize and depreciate the replacement roof over the same recovery period as the building. The temporary regulations revise the definition of disposition so that a taxpayer may treat the retirement of a structural component of a building as a disposition of property. Furthermore, the temporary regulations clarify that a taxpayer may recognize a loss on a component of a unit of property that is section 1245 property if the taxpayer consistently treats the component as a separate asset for disposition purposes. As a result, the 50 percent thresholds and the recovery period limitation are not necessary to prevent contemporaneous depreciation of both the retired component and the replacement component and, therefore, are not included in the temporary regulations as exceptions to the major component and substantial structural part rule.

VII. Accounting and Disposition Rules for MACRS Property

The temporary regulations revise the rules for accounting for assets to which section 168 applies (MACRS property) and the rules for determining gain or loss upon the disposition of MACRS property.

Currently, a taxpayer may account for its MACRS property by accounting for an asset individually in a single asset account, by combining two or more assets in a multiple asset account (or pool), or by electing to include the asset in a general asset account. The temporary regulations continue to allow these types of accounts. However, the rules under § 1.167(a)–7 for the different types of multiple asset accounts (specifically group account, classified account, and composite account) are based on a taxpayer being permitted to depreciate assets in the account over their useful lives or average useful lives (less salvage value). Since the enactment of the Accelerated Cost Recovery System (ACRS) in 1981, a taxpayer is required to depreciate assets over their recovery periods instead of their useful lives. Consequently, the temporary regulations eliminate group accounts, classified accounts, and composite accounts. Instead, the temporary regulations provide that each multiple asset account must include, in most cases, assets that have the same depreciation method, recovery period, and convention, and that are placed in service in the same taxable year.

Section 1.168–6 of the proposed ACRS regulations provides the rules for determining gain or loss upon the disposition of ACRS property. These rules generally have been applied to MACRS property. The temporary regulations provide rules for determining gain or loss upon the disposition of MACRS property that are consistent with the disposition rules under § 1.168–6 of the proposed ACRS regulations. However, as previously mentioned, the temporary regulations expand the definition of disposition for MACRS property to include the retirement of a structural component of a building and, accordingly, the temporary regulations allow the recognition of a loss upon such retirement. The temporary regulations also clarify that, if an asset is disposed of by physical abandonment and that asset is subject to nonrecourse indebtedness, the asset is treated in the same manner as an asset disposed of by sale. In addition, the temporary regulations provide rules for determining the asset disposed of and identifying which multiple asset account includes the asset disposed of.

The temporary regulations also amend the rules for general asset accounts under § 1.168(i)–1. Section 1.168(i)–1(e)(2) provides that, in general, no loss is recognized upon the disposition of an asset from a general asset account.

However, § 1.168–1(e)(3)(iii) provides that a taxpayer may elect to recognize gain or loss upon the disposition of an asset in a general asset account if there is a qualifying disposition. A qualifying disposition is defined to include a casualty loss, a charitable contribution, termination of a business or income producing activity, and certain types of transactions. The temporary regulations amend the general asset account rules by expanding the definition of disposition to include the retirement of a structural component of a building and by expanding the definition of a qualifying disposition to allow the recognition of gain or loss upon most dispositions of assets in general asset accounts. Thus, by electing general asset account treatment, a taxpayer will have the option of recognizing gain or loss on an expanded list of qualifying dispositions, which are not all treated as qualifying dispositions under the current general asset account rules. In addition, the temporary regulations modify the rules for establishing general asset accounts and clarify the computation of depreciation for a general asset account when the assets in the account are eligible for the additional first year depreciation deduction.

A. Accounting for MACRS property

The existing regulations under § 1.167(a)–7 allow a taxpayer to account for its depreciable assets by treating each asset as a single asset account or by combining two or more assets in a multiple asset account (or pool). A taxpayer may establish as many accounts for depreciable assets as the taxpayer wants and may group the assets in multiple asset accounts in different ways. When depreciation was determined using the useful lives of assets and average useful lives were permitted for an account, the common multiple asset accounts were a group account (assets similar in kind with approximately the same useful lives), a classified account (assets based on use without regard to useful life), and a composite account (assets in the same account without regard to their character or useful lives). The temporary regulations amend § 1.167(a)–7 to provide generally that those rules (which were originally issued in 1956) apply only to property subject to section 167 and not to MACRS property (generally property placed in service after 1986) or ACRS property (generally property placed in service after 1980 and before 1987).

The temporary regulations will, consistent with the rules under § 1.167(a)–7, continue to provide flexibility to a taxpayer in establishing its depreciable accounts for MACRS property. The temporary regulations under § 1.168(i)–7T allow a taxpayer to account for its MACRS property by treating each asset as a single asset account or by combining two or more assets in a multiple asset account. A taxpayer also may establish as many accounts for assets as the taxpayer wants. If a taxpayer chooses to account for its assets in multiple asset accounts, the temporary regulations provide that each multiple asset account must include assets that have the same depreciation method, recovery period, and convention, and are placed in service in the same taxable year. For example, in one multiple asset account, a taxpayer in the wholesale distribution business may account for most of its items of 5-year property that are placed in service in 2012 and have the same depreciation method, recovery period, and convention even though the assets may have different uses (for example, copiers, forklifts, and equipment in the distribution warehouse). Alternatively, the taxpayer may choose to account for the items of 5-year property in more than one multiple asset account, each as a single asset account, or in a combination of single and multiple asset accounts.

Even if assets have the same depreciation method, recovery period, and convention, depreciation for the assets may be computed differently. For example, depreciation may be limited for passenger automobiles subject to section 280F(a), or some assets may be eligible for the additional first year depreciation while others are not. As a result, the temporary regulations provide additional rules for establishing multiple asset accounts. For example, assets subject to the mid-month convention may be grouped in a multiple asset account only with assets placed in service in the same month. Similarly, assets eligible for the additional first year depreciation deduction cannot be grouped with assets ineligible for the additional first year depreciation deduction. Also, assets eligible for the additional first year depreciation deduction may be grouped only with assets eligible for the same percentage of the additional first year depreciation.

In limited circumstances, the temporary regulations require the use of a single asset account. A taxpayer must account for an asset in a single asset account if the taxpayer uses the asset both for business use and personal use, or the taxpayer places the asset in service and disposes of it in the same taxable year. A single asset account is also required for an asset that was included in a general asset account but general asset account treatment for the asset was terminated under the rules in § 1.168(i)–1T. Section 1.168(i)–7T does not apply to assets while they are included in general asset accounts subject to § 1.168(i)–1T.

B. Dispositions of MACRS Property

Section 168(i)(6) provides that an improvement or addition to property is depreciated under section 168 by using the depreciation method, recovery period, and convention that would be applicable to the underlying property if the underlying property is placed in service at the same time as the improvement or addition. If an improvement or addition to the underlying property is placed in service after the taxpayer placed the underlying property in service, the recovery period for the improvement or addition begins on the placed-in-service date of the improvement or addition. In effect, that improvement or addition is treated as a separate asset for purposes of section 168.

If a lessor made an improvement for a lessee and that improvement is irrevocably disposed of or abandoned by the lessor at the termination of the lease, section 168(i)(8)(B) allows the lessor to recognize gain or loss upon the disposition of that improvement. This rule applies to improvements that are structural components of a building. Similarly, if a lessee of a leased building makes an improvement that is a structural component of that building, the lessee may recognize gain or loss upon its disposition of that improvement.

However, § 1.168–2(l)(1) of the proposed ACRS regulations (which have been generally applied to MACRS property) provides that a disposition does not include the retirement of a structural component of a building. Consequently, § 1.168–6(b) of the proposed ACRS regulations provides that no loss is recognized upon the retirement of a structural component of a building.

As previously mentioned, the temporary regulations for determining whether there is an improvement to the unit of property take an approach different from the 2008 proposed regulations in order to achieve results more consistent with existing case law and to avoid the potential inequities resulting from the depreciation and disposition rules. As explained below, the temporary regulations expand the definition of disposition to include retirements of structural components of buildings and clarify that, in some cases, components of section 1245 property may be treated as the asset disposed of. These changes will allow taxpayers, for example, to claim a retirement loss for worn or damaged components that are discarded from the taxpayer's operations. On the other hand, a taxpayer that has elected general asset account treatment may choose not to claim a retirement loss for property that has been disposed of, and would accordingly continue to depreciate the basis in the property.

1. Definition of Disposition

Under the temporary regulations under § 1.168(i)–8T, a disposition occurs when ownership of the asset is transferred or when the asset is permanently withdrawn from use either in the taxpayer's trade or business or in the production of income. A disposition includes the sale, exchange, retirement, physical abandonment, or destruction of an asset. A disposition also includes the retirement of a structural component of a building. Finally, a disposition also occurs when an asset is transferred to a supplies, scrap, or similar account.

Prior to the enactment of ACRS in 1981, a taxpayer was permitted to depreciate the cost of property over its useful life (less salvage value), which was based on the taxpayer's subjective determination of the period over which the asset would be useful to the taxpayer in its trade or business or in the production of its income. Some taxpayers utilized component depreciation under this system in determining the useful life of buildings. Under component depreciation, a taxpayer allocates the cost of a building to its component parts and then assigns a separate useful life to each of these components. Each of the component parts is then depreciated as a separate asset. The ACRS rules prohibited the use of component depreciation and required composite depreciation for buildings. Composite depreciation was also required when the ACRS rules were modified in 1986 (generally referred to as ''MACRS,'' the modified rules generally applied to property placed in service after 1986). Under composite depreciation, a taxpayer depreciates a building and its structural components using the same recovery period and depreciation method. The temporary regulations do not change the requirement to use composite depreciation. Under section 168, a taxpayer must depreciate a building and all of its structural components using the same recovery period, depreciation method, and convention, even though under the temporary regulations each of the structural components is a separate asset.

2. Gain or Loss

The temporary regulations provide rules for determining gain or loss upon the disposition of MACRS property that are consistent with the disposition rules under § 1.167(a)–8 and § 1.168–6 of the proposed ACRS regulations. If an asset is disposed of by sale, exchange, or involuntary conversion, gain or loss is recognized under the applicable provisions of the Internal Revenue Code. If an asset is disposed of by physical abandonment, loss is recognized in the amount of the asset's adjusted depreciable basis at the time of the abandonment. However, if the abandoned asset is subject to nonrecourse indebtedness, the temporary regulations clarify that the asset is treated in the same manner as an asset disposed of by sale. If an asset is disposed of by conversion to personal use, no gain or loss is recognized. *See* § 1.168(i)–4(c). If an asset is disposed of other than by sale, exchange, involuntary conversion, physical abandonment, or conversion to personal use (for example, when the asset is transferred to a supplies or scrap account), gain is not recognized but loss is recognized in the amount of the excess of the asset's adjusted depreciable basis over its fair market value at the time of disposition. The temporary regulations also provide that the manner of disposition (for example, abnormal retirement or normal retirement) is not taken into consideration in determining whether a disposition occurs or gain or loss is recognized.

3. Determining the Appropriate Asset Disposed of

The temporary regulations provide that the facts and circumstances of each disposition are considered in determining the appropriate asset disposed of. In general, the asset for disposition purposes cannot be larger than the unit of property as determined under § 1.263(a)–3T(e)(2), (e)(3), and (e)(5) or as otherwise provided in published guidance in the **Federal Register** or in the Internal Revenue Bulletin (see, for example, Rev. Proc. 2011–28 (2011–18 IRB 743) providing units of property for wireless network assets). However, each disposed of building is the asset except if more than one building is treated as the asset under § 1.1250–1(a)(2)(ii). If the building includes two or more condominium or cooperative units, then each condominium or cooperative unit (instead of the building) is the asset. Consistent with the expansion of the definition of a disposition to include a retirement of a structural component of a building, the temporary regulations provide that each structural component of a building, condominium unit, or cooperative unit is the asset for disposition purposes. Further, if a taxpayer properly includes an item in one of the asset classes 00.11 through 00.4 of Rev. Proc. 87–56 (1987–2 CB 674) or classifies an item in one of the categories under section 168(e)(3) (other than a category that includes buildings or structural components; for example, retail motor fuels outlet and qualified leasehold improvement property), each item is the asset provided it is not larger than the unit of property as determined under § 1.263(a)–3T(e)(3) or (e)(5). For example, each desk is the asset, each computer is the asset, and each qualified smart electric meter is the asset (assuming these assets are not larger than the unit of property as determined under § 1.263(a)–3T(e)(3) or (e)(5)). Consistent with section 168(i)(6), the temporary regulations also provide that if the taxpayer places in service an improvement or addition to an asset after the taxpayer placed the asset in service, the improvement or addition is a separate asset for depreciation purposes. The temporary regulations also provide that a taxpayer generally may use any reasonable, consistent method to treat each of an asset's components as the asset for disposition purposes.

The temporary regulations provide rules for determining the placed-in-service year of the asset disposed of. In general, a taxpayer must use the specific identification method. Under this method, the taxpayer can determine when the asset disposed of was placed in service. If a taxpayer accounts for assets in multiple asset accounts, the IRS and the Treasury Department recognize that it may be impracticable to determine from the taxpayer's records when the asset disposed of was placed in service. Accordingly, the temporary regulations allow the taxpayer to use a first-in, first-out (FIFO) method under which the taxpayer treats the asset disposed of as being from the multiple asset account with the earliest placed-in-service year that has assets with the same recovery period as the asset disposed of. However, if the taxpayer can readily determine from its records the unadjusted depreciable basis of the asset disposed of, the temporary regulations allow the taxpayer to use a modified FIFO method under which the taxpayer treats the asset disposed of as being from the multiple asset account with the earliest placed-in-service year that has assets with the same recovery period as the asset disposed of and with the same unadjusted depreciable basis of the asset disposed of. If the asset disposed of is a mass asset in a multiple asset account, the temporary regulations also allow the taxpayer to use a mortality dispersion table to identify when the asset was placed in service. Finally, the temporary regulations allow a taxpayer to use any other method designated by the Secretary. The IRS and the Treasury Department invite taxpayers to submit comments on reasonable methods to be considered for this purpose. However, the IRS and the Treasury Department do not consider a last-in, last-out (LIFO) method to be a reasonable method. Under the LIFO method, the taxpayer treats the asset disposed of as being from the multiple asset account with the most recent placed-in-service year that has assets with the same recovery period as the asset disposed of.

4. Accounting for Assets Disposed of

The IRS and the Treasury Department recognize that it may be impracticable for a taxpayer that accounts for assets in multiple asset accounts to determine from the taxpayer's records the unadjusted depreciable basis of the asset disposed of. Accordingly, the temporary regulations provide that the taxpayer may use any reasonable, consistent method to make that determination. Similar rules are provided if the asset disposed of is a component of a larger asset.

When an asset is disposed of, the temporary regulations provide that depreciation ends for that asset. *See* § 1.167(a)–10(b). Accordingly, if the asset disposed of is in a single asset account, the temporary regulations provide that the single asset account terminates as of the date of disposition (taking into account the applicable convention of the asset disposed of). Also, if the asset disposed of is in a multiple asset account, the temporary regulations provide that the asset is removed from that account and the unadjusted depreciable basis and depreciation reserve of the account are adjusted. Similar rules are provided if the asset disposed of is a component of a larger asset.

The temporary regulations also provide that the § 1.167(a)–8 rules apply to property subject to section 167 and not to MACRS property (generally property placed in service after 1986) or ACRS property (generally property placed in service after 1980 and before 1987).

C. General Asset Accounts

Section 168(i)(4) provides that under regulations, a taxpayer may maintain one or more general asset accounts for any MACRS property. Except as provided in regulations, all proceeds realized on any disposition of property in a general asset account shall be included in income as ordinary income.

The existing rules for general asset accounts are provided under § 1.168(i)–1. The provisions of § 1.168(i)–1 apply only to assets for which the taxpayer has made an election to account for the assets in general asset accounts. The temporary regulations for general asset accounts under § 1.168(i)–1T retain this rule. Under the existing rules and temporary regulations, each general asset account is effectively treated as the asset.

1. Establishing General Asset Accounts

Consistent with the existing general asset account rules under § 1.168(i)–1(c), the temporary regulations provide that assets may be grouped into one or more general asset accounts. The temporary regulations, however, expand the assets that may be included in each general asset account. The temporary regulations eliminate the existing rule that each general asset account must include only assets that have the same asset class. Thus, under the temporary regulations, each general asset account must include only assets that have the same depreciation method, recovery period, and convention, and are placed in service in the same taxable year.

The existing general asset account rules also provide special rules for establishing general asset accounts. These rules are necessary because even though assets have the same depreciation method, recovery period, and convention, depreciation for the assets may be computed differently. As a result, the temporary regulations do not change the existing rules, but they add new rules to be consistent with the temporary regulations for establishing multiple asset accounts for MACRS property. For example, assets eligible for the additional first year depreciation deduction cannot be grouped with assets ineligible for the additional first year depreciation deduction. Also, assets eligible for the additional first year depreciation deduction may be grouped only with assets eligible for the same percentage of the additional first year depreciation.

2. Depreciation of General Asset Account

Section 1.168(i)–1(d) provides the rules for determining the depreciation for each general asset account. However, these rules do not reflect the additional first year depreciation provisions added to section 168 since the promulgation of § 1.168(i)–1 in 1994. Accordingly, the temporary regulations provide rules for determining the depreciation for a general asset account where all the assets in the account are eligible for the additional first year depreciation deduction and where all the assets in the account are not eligible for that deduction.

3. Disposition of an Asset From a General Asset Account

Consistent with the expansion of the definition of disposition of MACRS property, the temporary regulations expand the definition of disposition under § 1.168(i)–1(e)(1) to include a retirement of a structural component of a building.

Immediately before any disposition of an asset in a general asset account, the existing rules treat the asset as having an adjusted depreciable basis of zero for purposes of section 1011. Therefore, no loss is realized upon the disposition of the asset. The existing rules also provide that any amount realized on a disposition generally is recognized as ordinary income. Further, the existing rules provide that the unadjusted depreciable basis and depreciation reserve of the general asset account are not affected by the disposition. Accordingly, a taxpayer continues to depreciate the general asset account, including the asset disposed of, as though no disposition occurred. The temporary regulations do not change any of these rules.

The existing rules also allow a taxpayer to terminate general asset account treatment upon certain dispositions. Under the existing rules, the taxpayer may elect to recognize gain or loss for a general asset account when the taxpayer disposes of all of the assets, or the last asset, in the account. The temporary regulations retain this rule.

The existing rules further allow a taxpayer to elect to terminate general asset account treatment for an asset in a general asset account when the taxpayer disposes of the asset in a qualifying disposition. Under the existing rules, a qualifying disposition generally is a casualty or extraordinary event. The temporary regulations expand a qualifying disposition to include generally any disposition. If a taxpayer elects to terminate general asset account treatment for an asset disposed of in a qualifying disposition, the temporary regulations do not change the existing rules that require the taxpayer to remove the asset disposed of from the general asset account and adjust the unadjusted depreciable basis and depreciation reserve of the account.

The temporary regulations also do not change the existing rules that require a taxpayer to terminate general asset account treatment for assets in a general asset account that are disposed of in transactions subject to section 167(i)(7)(B), section 1031, or section 1033, or in an abusive transaction described under the existing rules. In addition, the temporary regulations require a partnership to terminate its general asset accounts upon the technical termination of the partnership under section 708(b)(1)(B).

4. Other Transactions

The temporary regulations require a taxpayer to terminate general asset account treatment for an asset that the taxpayer uses for both business use and personal use. If there is a redetermination of basis of an asset in a general asset account (for example, due to contingent purchase price or discharge of indebtedness), the temporary regulations provide that the election for the asset also applies to the increase or decrease in basis and require the taxpayer to establish a new general asset account for that increase or decrease in basis.

5. Identification of Disposed of or Converted Asset

Because the general asset account is the asset, the existing rules provide that a taxpayer may use any reasonable method that is consistently applied to all of its general asset accounts for determining the unadjusted depreciable basis of an asset for which general asset account treatment is terminated. The temporary regulations retain this rule but provide what methods are reasonable for identifying the placed-in-service year of the asset disposed of. These methods are the same as those discussed above for identifying the placed-in-service year of an asset disposed of in a multiple asset account: the specific identification method, the FIFO method, the modified FIFO method, a mortality dispersion table if the asset disposed of is a mass asset grouped in a general asset account with other mass assets, or any method designated by the Secretary. The LIFO method is not permitted.

The temporary regulations also amend §§ 1.165–2 and 1.1016–3 to include cross-references to §§ 1.168(i)–1T and 1.168(i)–8T.

VIII. Effective Dates and Changes in Methods of Accounting

The preamble to the 2008 proposed regulations provided that a change to conform to the proposed regulations upon finalization will be considered a change in method of accounting under section 446(e). The 2008 proposed regulations, however, were not effective until issued as final regulations and thus did not provide specific procedures for changes in method of accounting.

The IRS and the Treasury Department received several comments regarding the procedures that a taxpayer should utilize to change its method of accounting to comply with the regulations. Several commentators favored the use of a cut-off method, primarily for reasons of administrative convenience. However, other commentators asserted that any change in method of accounting must include a section 481(a) adjustment.

The temporary regulations under § 1.162–3T are generally effective for amounts paid or incurred (to acquire or produce property) in taxable years beginning on or after January 1, 2012, except for § 1.162–3T(e), which is effective for taxable years beginning on or after January 1, 2012. The temporary regulations under §§ 1.167(a)–4, 1.167(a)–7T, 1.167(a)–8T, 1.168(i)–1T, 1.168(i)–7T, 1.168(i)–8T, 1.263(a)–1T, 1.263(a)–2T, 1.263(a)–3T, 1.263(a)–6T, and 1.1016–3T are generally effective for taxable years beginning on or after January 1, 2012, except for §§ 1.263(a)–2T(f)(2)(iii), (f)(2)(iv), (f)(3)(ii), and (g), which are effective for amounts paid or incurred (to acquire or produce property) in taxable years beginning on or after January 1, 2012. In addition, the temporary regulations under § 1.263A–1T are effective for amounts paid or incurred (to acquire or produce property) in taxable years beginning on or after January 1, 2012.

As stated in the preamble to the 2008 proposed regulations, a change to conform to these regulations will be a change in method of accounting under section 446(e). In general, a taxpayer seeking a change in method of accounting to comply with these temporary regulations must take into account an adjustment under section 481(a). Procedures will be provided under which taxpayers may obtain automatic consent for a taxable year beginning on or after Jan 1, 2012 to change to a method of accounting provided in the temporary regulations.

The imposition of a section 481(a) adjustment for a change in method of accounting to conform to the temporary regulations provides for a uniform and consistent rule for all taxpayers and ultimately reduces the administrative burdens on taxpayers and the IRS in enforcing the requirements of section 263(a). Although the IRS and the Treasury Department recognize that requiring a section 481(a) adjustment may place a burden on taxpayers to calculate reasonable adjustments, taxpayers have shown a willingness and ability to make these calculations in requesting method changes after the publication of the 2008 proposed regulations. In addition, taxpayers and the IRS routinely reach agreements on calculation methodologies and amounts. Moreover, by utilizing a section 481(a) adjustment to make the change, a taxpayer is put on the same method of accounting for all amounts or costs incurred both prior to and after the effective date of these regulations. Furthermore, a section 481(a) adjustment results in similar treatment for all taxpayers, including those that changed their method of accounting in response to the 2008 proposed regulations. Finally, requiring a section 481(a) adjustment reduces the burden for taxpayers and the IRS during examinations that include years both before and after the effective date of these regulations because the parties will need to apply only the temporary regulations, and will not need to apply the rules in effect prior to the effective date of the temporary regulation.

Comments and Public Hearing

The text of these temporary regulations also serves as the text of the proposed regulations set forth in a notice of proposed rulemaking on this subject appearing elsewhere in this issue of the **Federal Register**. Please see the ''Comments and Public Hearing'' section of the notice of proposed rulemaking for the procedures to follow for submitting comments and requesting to speak at the public hearing on the proposed regulations on this subject.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f), these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these regulations are Merrill D. Feldstein and Kathleen Reed, Office of the Associate Chief Counsel (Income Tax and Accounting). Other personnel from the IRS and the Treasury Department have participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *
Section 1.168(i)–1T also issued under 26 U.S.C. 168(i)(4). * * *

■ **Par. 2.** Section 1.162–3 is revised to read as follows:

§ 1.162–3 Materials and Supplies.

(a) through (j) [Reserved]. For further guidance, see § 1.162–3T(a) through (j).

■ **Par. 3.** Section 1.162–3T is added to read as follows:

§ 1.162–3T Materials and supplies (temporary).

(a) *In general*—(1) *Non-incidental materials and supplies.* Amounts paid to acquire or produce materials and supplies are deductible in the taxable year in which the materials and supplies are used or consumed in the taxpayer's operations.

(2) *Incidental materials and supplies.* Amounts paid to acquire or produce incidental materials and supplies that are carried on hand and for which no record of consumption is kept or of which physical inventories at the beginning and end of the taxable year are not taken, are deductible in the taxable year in which these amounts are paid, provided taxable income is clearly reflected.

(3) *Use or consumption of rotable and temporary spare parts.* Except as provided in paragraphs (d), (e), and (f) of this section, for purposes of paragraph (a)(1) of this section, rotable and temporary spare parts (defined under paragraph (c)(2) of this section) are used or consumed in the taxpayer's operations in the taxable year in which the taxpayer disposes of the parts.

(b) *Coordination with other provisions of the Internal Revenue Code.* Nothing in this section changes the treatment of any amount that is specifically provided for under any provision of the Internal Revenue Code or regulations other than section 162(a) or section 212 and the regulations under those sections. For example, see section § 1.263(a)–3T, which requires taxpayers to capitalize amounts paid to improve tangible property and section 263A and the regulations under section 263A, which require taxpayers to capitalize the direct and allocable indirect costs, including the cost of materials and supplies, to property produced or to property acquired for resale. See also § 1.471–1, which requires taxpayers to include in inventory certain materials and supplies.

(c) *Definitions*—(1) *Materials and supplies.* For purposes of this section, *materials and supplies* means tangible property that is used or consumed in the taxpayer's operations that is not inventory and that—

(i) Is a component acquired to maintain, repair, or improve a unit of tangible property (as determined under § 1.263(a)–3T(e)) owned, leased, or serviced by the taxpayer and that is not acquired as part of any single unit of tangible property;

(ii) Consists of fuel, lubricants, water, and similar items, that are reasonably expected to be consumed in 12 months or less, beginning when used in taxpayer's operations;

(iii) Is a unit of property as determined under § 1.263(a)–3T(e) that has an economic useful life of 12 months or less, beginning when the property is used or consumed in the taxpayer's operations;

(iv) Is a unit of property as determined under § 1.263(a)-3T(e) that has an acquisition cost or production cost (as determined under section 263A) of $100 or less (or other amount as identified in published guidance in the **Federal Register** or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter)); or

(v) Is identified in published guidance in the **Federal Register** or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter) as materials and supplies for which treatment is permitted under this section.

(2) *Rotable and temporary spare parts.* For purposes of this section, rotable spare parts are materials and supplies under paragraph (c)(1)(i) of this section that are acquired for installation on a unit of property, removable from that unit of property, generally repaired or improved, and either reinstalled on the same or other property or stored for later installation. Temporary spare parts are materials and supplies under paragraph (c)(1)(i) of this section that are used temporarily until a new or repaired part can be installed and then are removed and stored for later (emergency or temporary) installation.

(3) *Economic useful life*—(i) *General rule.* The economic useful life of a unit of property is not necessarily the useful life inherent in the property but is the period over which the property may reasonably be expected to be useful to the taxpayer or, if the taxpayer is engaged in a trade or business or an activity for the production of income, the period over which the property may reasonably be expected to be useful to the taxpayer in its trade or business or for the production of income, as applicable. See § 1.167(a)–1(b) for the factors to be considered in determining this period.

(ii) *Taxpayers with an applicable financial statement.* For taxpayers with an applicable financial statement (as defined in paragraph (c)(3)(iii) of this section), the economic useful life of a unit of property, solely for the purposes of applying the provisions of paragraph (c)(1)(iii) of this section, is the useful life initially used by the taxpayer for purposes of determining depreciation in its applicable financial statement, regardless of any salvage value of the property. If a taxpayer does not have an applicable financial statement for the taxable year in which a unit of property was originally acquired or produced, the economic useful life of the unit of property must be determined under paragraph (c)(3)(i) of this section. Further, if a taxpayer treats amounts paid for a unit of property as an expense in its applicable financial statement on a basis other than the useful life of the property or if a taxpayer does not depreciate the unit of property on its applicable financial statement, the economic useful life of the unit of property must be determined under paragraph (c)(3)(i) of this section. For example, if a taxpayer has a policy of treating as an expense on its applicable financial statement amounts paid for a unit of property costing less than a certain dollar amount, notwithstanding that the unit of property has a useful life of more than one year, the economic useful life of the unit of property must be determined under paragraph (c)(3)(i) of this section.

(iii) *Definition of applicable financial statement.* The taxpayer's applicable financial statement is the taxpayer's financial statement listed in paragraphs (c)(3)(iii)(A) through (C) of this section that has the highest priority (including within paragraph (c)(3)(iii)(B) of this section). The financial statements are, in descending priority—

(A) A financial statement required to be filed with the Securities and Exchange Commission (SEC) (the 10–K or the Annual Statement to Shareholders);

(B) A certified audited financial statement that is accompanied by the report of an independent CPA (or in the case of a foreign entity, by the report of a similarly qualified independent professional), that is used for—

(*1*) Credit purposes;

(*2*) Reporting to shareholders, partners, or similar persons; or

(*3*) Any other substantial non-tax purpose; or

(C) A financial statement (other than a tax return) required to be provided to the Federal or a state government or any Federal or state agencies (other than the SEC or the Internal Revenue Service).

(4) *Amount paid.* For purposes of this section, in the case of a taxpayer using an accrual method of accounting, the terms *amount paid* and *payment* mean a liability incurred (within the meaning of § 1.446–1(c)(1)(ii)). A liability may not be taken into account under this section prior to the taxable year during which the liability is incurred.

(5) *Produce.* For purposes of this section, *produce* means construct, build, install, manufacture, develop, create, raise, or grow. This definition is intended to have the same meaning as the definition used for purposes of section 263A(g)(1) and § 1.263A–2(a)(1)(i), except that improvements are excluded from the definition in this paragraph (c)(5) and are separately defined and addressed in § 1.263(a)–3T. Amounts paid to produce materials and supplies are subject to section 263A.

(d) *Election to capitalize and depreciate*—(1) *In general.* A taxpayer may elect to treat as a capital expenditure and to treat as an asset subject to the allowance for depreciation the cost of any material or supply as defined in paragraph (c)(1) of this section. Except as specified in paragraph (d)(2) of this section, an election made under this paragraph (d) applies to amounts paid during the taxable year to acquire or produce any material or supply to which paragraph (a) of this section would apply (but for the election under this paragraph (d)). Any asset for which this election is made shall not be treated as a material or a supply.

(2) *Exceptions.* A taxpayer may not elect to capitalize and depreciate under paragraph (d) of this section—

(i) Any amount paid to acquire or produce a material or supply described in paragraph (c)(1)(i) of this section if—

(A) The material or supply is intended to be used as a component of a unit of property that is a material or supply under paragraph (c)(1)(iii), (iv), or (v) of this section; and

(B) The taxpayer has not elected to capitalize and depreciate that unit of property under this paragraph (d); or

(ii) Any amount paid to acquire or produce a rotable or temporary spare part if the taxpayer has applied the optional method of accounting for rotable and temporary spare parts under paragraph (e) of this section.

(3) *Manner of electing.* A taxpayer makes the election under paragraph (d) of this section by capitalizing the amounts paid to acquire or produce a material or supply in the taxable year the amounts are paid and by beginning to recover the costs when the asset is placed in service by the taxpayer for the purposes of determining depreciation under the applicable provisions of Internal Revenue Code and regulations thereunder. A taxpayer must make this election in its timely filed original Federal income tax return (including extensions) for the taxable year the asset is placed in service by the taxpayer for purposes of determining depreciation. See § 1.263(a)–2 for the treatment of amounts paid to acquire or produce real or personal tangible property. In the case of a pass-through entity, the election is made by the pass-through entity, and not by the shareholders or partners. A taxpayer may make an election for each material or supply that qualifies for the election under this paragraph (d). A taxpayer may revoke an election made under this paragraph (d) with respect to a material or supply only by filing a request for a private letter ruling and obtaining the Commissioner's consent to revoke the election. The Commissioner may grant a request to revoke this election if the taxpayer can demonstrate good cause for the revocation. An election may not be made or revoked through the filing of an application for change in accounting method or, before obtaining the Commissioner's consent to make the late election or to revoke the election, by filing an amended Federal income tax return.

(e) *Optional method of accounting for rotable and temporary spare parts*—(1) *In general.* This paragraph (e) provides an optional method of accounting for rotable and temporary spare parts (the optional method for rotables). A taxpayer may use the optional method for rotables, instead of the general rule under paragraph (a)(3) of this section, to account for its rotable and temporary spare parts as defined in paragraph (c)(2) of this section. A taxpayer that uses the optional method for rotables must use this method for all of its rotable and temporary spare parts in the same trade or business. The optional method for rotables is a method of accounting under section 446(a). Under the optional method for rotables, the taxpayer must apply the rules in this paragraph (e) to each rotable or temporary spare part (part) upon the taxpayer's initial installation, removal, repair, maintenance or improvement, reinstallation, and disposal of each part.

(2) *Description of optional method for rotables*—(i) *Initial installation.* The taxpayer must deduct the amount paid to acquire or produce the part in the taxable year that the part is first installed on a unit of property for use in the taxpayer's operations.

(ii) *Removal from unit of property.* In each taxable year in which the part is removed from a unit of property to which it was initially or subsequently installed, the taxpayer must—

(A) Include in gross income the fair market value of the part; and

(B) Include in the basis of the part the fair market value of the part included in income under paragraph (e)(2)(ii)(A) of this section and the amount paid to remove the part from the unit of property.

(iii) *Repair, maintenance, or improvement of part.* The taxpayer may not currently deduct and must include in the basis of the part any amounts paid to maintain, repair, or improve the part in the taxable year these amounts are paid.

(iv) *Reinstallation of part.* The taxpayer must deduct the amounts paid to reinstall the part and those amounts included in the basis of the part under paragraphs (e)(2)(ii)(B) and (e)(2)(iii) of this section, to the extent that those amounts have not been previously deducted under this paragraph (e)(2)(iv), in the taxable year that the part is reinstalled on a unit of property.

(v) *Disposal of the part.* The taxpayer must deduct the amounts included in the basis of the part under paragraphs (e)(2)(ii)(B) and (e)(2)(iii) of this section, to the extent that those amounts have not been previously deducted under paragraph (e)(2)(iv) of this section, in the taxable year in which the part is disposed of by the taxpayer.

(f) *Election to apply de minimis rule*—(1) *In general.* A taxpayer may elect to apply the de minimis rule under § 1.263(a)–2T(g) to any material or supply defined in paragraph (c)(1) this section. Any material or supply to which the taxpayer elects to apply the de minimis rule under § 1.263(a)–2T(g) is not treated as a material or supply under this section. *See* § 1.263(a)–2T(g)(5).

(2) *Manner of electing.* A taxpayer makes the election by deducting the amounts paid to acquire or produce a material or supply in the taxable year that the amounts are paid and by complying with the requirements set out in § 1.263(a)–2T(g). A taxpayer must make this election in its timely filed original Federal income tax return (including extensions) for the taxable year that amounts are paid for the material or supply. In the case of a pass-through entity, the election is made by the pass-through entity and not by the shareholders or partners. A taxpayer may make an election for each material or supply that qualifies for the election under paragraph (f) of this section. A taxpayer may revoke an election made under paragraph (f) of this section with respect to a material or supply only by filing a request for a private letter ruling and obtaining the Commissioner's consent to revoke the election. The Commissioner may grant a request to revoke this election if the taxpayer can demonstrate good cause for the revocation. An election may not be made or revoked through the filing of an application for change in accounting method or, before obtaining the Commissioner's consent to make the late election or to revoke the election, by filing an amended Federal income tax return.

(g) *Sale or disposition of materials and supplies.* Upon sale or other disposition, materials and supplies as defined in this section are not treated as a capital asset under section 1221 or as property used in the trade or business under section 1231. Any asset for which the taxpayer makes the election to capitalize and depreciate under paragraph (d) of this section shall not be treated as a material or supply.

(h) *Examples.* The rules of this section are illustrated by the following examples, in which it is assumed (unless otherwise stated) that the property is not an incidental material or supply, that the taxpayer is a calendar year, accrual method taxpayer, and that the taxpayer has not elected to capitalize under paragraph (d) of this section or to apply the de minimis rule under paragraph (f) of this section.

Example 1. Non-rotable components. X owns a fleet of aircraft that it operates in its business. In Year 1, X purchases a stock of spare parts, which it uses to maintain and repair its aircraft. X keeps a record of consumption of these spare parts. In Year 2, X uses the spare parts for the repair and maintenance of one of its aircraft. Assume each aircraft is a unit of property under § 1.263(a)–3T(e) and that spare parts are not rotable or temporary spare parts under paragraph (c)(2) of this section. Assume these repair and maintenance activities do not improve the aircraft under § 1.263(a)–3T. These parts are materials and supplies under paragraph (c)(1)(i) of this section because they are components acquired and used to maintain and repair X's aircraft. Under paragraph (a)(1) of this section, the amounts that X paid for the spare parts in Year 1 are deductible in Year 2, the taxable year in which the spare parts are used to repair and maintain the aircraft.

Example 2. Rotable spare parts. X operates a fleet of specialized vehicles that it uses in its service business. Assume that each vehicle is a unit of property under § 1.263(a)–3T(e). At the time that it acquires a new type of vehicle, X also acquires a substantial number of rotable spare parts that it will keep on hand to quickly replace similar parts in X's vehicles as those parts break down or wear out. These rotable parts are removable from the vehicles and are repaired so that they can be reinstalled on the same or similar vehicles. X does not use the optional method of accounting for rotable and temporary spare parts provided in paragraph (e) of this section. In Year 1, X acquires several vehicles and a number of rotable spare parts to be used as replacement parts in these vehicles. In Year 2, X repairs several vehicles by using these rotable spare parts to replace worn or damaged parts. In Year 3, X removes these rotable spare parts from its vehicles, repairs the parts, and reinstalls them on other similar vehicles. In Year 5, X can no longer use the rotable parts it acquired in Year 1 and disposes of them as scrap. Under paragraph (c)(1)(i) of this section, the rotable spare parts acquired in Year 1 are materials and supplies. Under paragraph (a)(3) of this section, rotable spare parts are generally used or consumed in the taxable year in which the taxpayer disposes of the parts. Therefore, under paragraph (a)(1) of this section, the amounts that X paid for the rotable spare parts in Year 1 are deductible in Year 5, the taxable year in which X disposes of the parts.

Example 3. Rotable spare parts; application of optional method of accounting. Assume the same facts as in *Example 2,* except X uses the optional method of accounting for all its rotable and temporary spare parts under paragraph (e) of this section. In Year 1, X acquires several vehicles and a number of rotable spare parts (the ''Year 1 rotables'') to be used as replacement parts in these vehicles. In Year 2, X repairs several vehicles and uses the Year 1 rotables to replace worn or damaged parts. In Year 3, X pays amounts to remove these Year 1 rotables from its vehicles. In Year 4, X pays amounts to maintain, repair, or improve the Year 1 rotables. In Year 5, X pays amounts to reinstall the Year 1 rotables on other similar vehicles. In Year 8, X removes the Year 1 rotables from these vehicles and stores these parts for possible later use. In Year 9, X disposes of the Year 1 rotables. Under paragraph (e) of this section, X must deduct the amounts paid to acquire and install the Year 1 rotables in Year 2, the taxable year in which the rotable spare parts are first installed by X in X's vehicles. In Year 3, when X removes the Year 1 rotables from its vehicles, X must include in its gross income the fair market value of each part. Also, in Year 3, X must include in the basis of each Year 1 rotable the fair market value of the rotable and the amount paid to remove the rotable from the vehicle. In Year 4, X must include in the basis of each Year 1 rotable the amounts paid to maintain, repair, or improve each rotable. In Year 5, the year that X reinstalls the Year 1 rotables (as repaired or improved) in other vehicles, X must deduct the reinstallation costs and the amounts previously included in the basis of each part. In Year 8, the year that X removes the Year 1 rotables from the vehicles, X must include in income the fair market value of each rotable part removed. In addition, in Year 8, X must include in the basis of each part the fair market value of that part and the amount paid to remove the each rotable from the vehicle. In Year 9, the year that X disposes of the Year 1 rotables, X may deduct the amounts remaining in the basis of each rotable.

Example 4.' Rotable part acquired as part of a single unit of property; not material or supply. X operates a fleet of aircraft. In Year 1, X acquires a new aircraft, which includes two new aircraft engines. The aircraft costs $500,000 and has an economic useful life of more than 12 months, beginning when it is placed in service. In Year 5, after the aircraft is operated for several years in X's business, X removes the engines from the aircraft, repairs or improves the engines, and either reinstalls the engines on a similar aircraft or stores the engines for later reinstallation. Assume the aircraft purchased in Year 1, including its two engines, is a unit of property under § 1.263(a)–3T(e). Because the engines were acquired as part of the aircraft, a single unit of property, the engines are not materials or supplies under paragraph (c)(1)(i) of this section nor rotable or temporary spare parts under paragraph (c)(2) of this section. Accordingly, X may not apply the rules of this section to the aircraft engines upon the original acquisition of the aircraft nor after the removal of the engines from the aircraft for use in the same or similar aircraft. Rather, X must apply the rules under §§ 1.263(a)–2T and 1.263(a)–3T to the aircraft, including its engines, to determine the treatment of amounts paid to acquire, produce, or improve the unit of property.

Example 5. Components of real property. X owns an apartment building that it leases in its business operation and discovers that a window in one of the apartments is broken. Assume that the building, including its windows, is a unit of property under § 1.263(a)–3T(e) and the window is not a rotable or temporary spare part under paragraph (c)(2) of this section. X pays for the acquisition and delivery of a new window to replace the broken window. In the same taxable year, the new window is installed. Assume that the replacement of the window does not improve the property under § 1.263(a)–3T and that X does not recognize gain or loss on the disposition of the broken window. The new window is a material or supply under paragraph (c)(1)(i) of this section because it is a component acquired and used to repair a unit of property owned by X and used in X's operations. Under paragraph (a)(1) of this section, the amounts X paid for the acquisition and delivery of the window are deductible in the taxable year in which the window is installed in the apartment building. See § 1.168(i)–8T for the treatment of the disposition of the broken window.

Example 6. Consumable property. X operates a fleet of aircraft that carries freight for its customers. X has several storage tanks on its premises, which hold jet fuel for its aircraft. Assume that once the jet fuel is placed in X's aircraft, the jet fuel is reasonably expected to be consumed within 12 months or less. On December 31, Year 1, X purchases a two-year supply of jet fuel. In Year 2, X uses a portion of the jet fuel purchased on December 31, Year 1, to fuel the aircraft used in its business. The jet fuel that X purchased in Year 1 is a material or supply under paragraph (c)(1)(ii) of this section because it is reasonably expected to be consumed within 12 months or less from the time it is placed in X's aircraft. Under paragraph (a)(1) of this section, X may deduct in Year 2 the amounts paid for the portion of jet fuel used in the operation of X's aircraft in Year 2.

Example 7. Unit of property that costs $100 or less. X operates a business that rents out a variety of small individual items to customers (rental items). X maintains a supply of rental items on hand. In Year 1, X purchases a large quantity of rental items to use in its rental business. Assume that each rental item is a unit of property under § 1.263(a)–3T(e) and costs $100 or less. In Year 2, X begins using all the rental items purchased in Year 1 by providing them to customers of its rental business. X does not sell or exchange these items on established retail markets at any time after the items are used in the rental business. The rental items are materials and supplies under paragraph (c)(1)(iv) of this section. Under paragraph (a)(1) of this section, the amounts that X paid for the rental items in Year 1 are deductible in Year 2, the taxable year in which the rental items are used in X's business.

Example 8. Unit of property that costs $100 or less. X provides billing services to its customers. In Year 1, X pays amounts to purchase 50 facsimile machines to be used by its employees. Assume each facsimile machine is a unit of property under § 1.263(a)–3T(e) and costs less than $100. In Year 1, X's employees begin using 35 of the facsimile machines, and X stores the remaining 15 machines for use in a later taxable year. The facsimile machines are materials and supplies under paragraph (c)(1)(iv) of this section. Under paragraph (a)(1) of this section, the amounts X paid for 35 of the facsimile machines are deductible in Year 1, the taxable year in which X uses those machines. The amounts that X paid for each of the remaining 15 machines are deductible in the taxable year in which each machine is used.

Example 9. Materials and supplies used in improvements; coordination with § 1.263(a)–3T. X owns various machines that are used in its business. Assume that each machine is a unit of property under § 1.263(a)–3T(e). In Year 1, X purchases a supply of spare parts for its machines. X acquired the parts to use in the repair or maintenance of the machines under § 1.162–4T or in the improvement of the machines under § 1.263(a)–3T. The spare parts are not rotable or temporary spare parts under paragraph (c)(2) of this section. In Year 2, X uses all of these spare parts in an activity that improves a machine under § 1.263(a)–3T. Under paragraph (c)(1)(i) of this section, the spare parts purchased by X in Year 1 are materials and supplies. Under paragraph (a)(1) of this section, the amounts paid for the spare parts are otherwise deductible as materials and supplies in Year 2, the taxable year in which X uses those parts. However, because these materials and supplies are used to improve X's machine, X is required to capitalize the amounts paid for those spare parts under § 1.263(a)–3T. See also section 263A for the requirement to capitalize the direct and allocable indirect costs of property produced or property acquired for resale.

Example 10. Cost of producing materials and supplies; coordination with section 263A. X is a manufacturer that produces liquid waste as part of its operations. X determines that its current liquid waste disposal process is inadequate. To remedy the problem, in Year 1, X constructs a leaching pit to provide a draining area for the liquid waste. Assume the leaching pit is a unit of property under § 1.263(a)–3T(e) and has an economic useful life 12 months or less, starting on the date that X begins to use the leaching pit as a draining area. At the end of this period, X's factory will be connected to the local sewer system. In Year 2, X starts using the leaching pit in its operations. The amounts paid to construct the leaching pit (including the direct and allocable indirect costs of property produced under section 263A) are amounts paid for a material or supply under paragraph (c)(1)(iii) of this section. Under paragraph (a)(1) of this section, the amounts paid for the leaching pit are otherwise deductible as materials and supplies in Year 2, the taxable year in which X uses the leaching pit. However, because the amounts paid to construct the leaching pit directly benefit or are incurred by reason of X's manufacturing operations, X must capitalize those costs under section 263A to the property produced. *See* § 1.263A–1(e)(3)(ii)(E).

Example 11. Costs of acquiring materials and supplies for production of property; coordination with section 263A. In Year 1, X purchases jigs, dies, molds, and patterns for use in the manufacture of X's products. Assume each jig, die, mold, and pattern is a unit of property under § 1.263(a)–3T(e). The economic useful life of each jig, die, mold, and pattern is 12 months or less, beginning when each item is used in the manufacturing process. The jigs, dies, molds, and patterns are not components acquired to maintain, repair, or improve any of X's equipment under paragraph (c)(1)(i) of this section. X begins using the jigs, dies, molds and patterns in Year 2 to manufacture its products. These items are materials and supplies under paragraph (c)(1)(iii) of this section. Under paragraph (a)(1) of this section, the amounts paid for the items are otherwise deductible in Year 2, the taxable year in which X uses those items. However, because the amounts paid for these materials and supplies directly benefit or are incurred by reason of X's manufacturing operations, X must capitalize the costs under section 263A to the property produced. *See* § 1.263A–1(e)(3)(ii)(E).

Example 12. Election to capitalize and depreciate. X operates a rental business that rents out a variety of items (rental items) to its customers. Assume each rental item is a separate unit of property as determined under § 1.263(a)–3T(e). X does not sell or exchange these items on established retail markets at any time after the items are used in the rental business. X purchases various rental items, each of which costs less than $100 or has an economic useful life of 12 months or less, beginning when the items are used or consumed. The rental items are materials and supplies under paragraph (c)(1)(iii) or (c)(1)(iv) of this section. Under paragraph (a)(1) of this section, the amount paid for each rental item is deductible in the taxable year in which the item is used in the rental business. However, X would prefer to treat the cost of each rental item as a capital expenditure subject to depreciation. Under paragraph (d) of this section, X may elect not to apply the rule contained in paragraph (a)(1) of this section to the rental items. X makes this election by capitalizing the amounts paid for each rental item in the taxable year that X purchases the item and by beginning to recover the costs of each item on its timely filed Federal income tax return for the taxable year that X places the item in service for purposes of determining depreciation under the applicable provisions of the Internal Revenue Code and the regulations thereunder. See § 1.263(a)–2T(h) for the treatment of capital expenditures.

Example 13. Election to capitalize and depreciate. X is an electric utility. X acquires certain temporary spare parts, which it keeps on hand to avoid operational time loss in the event it must make emergency repairs to a unit of property that is subject to depreciation. These parts are not used to improve property under § 1.263(a)–3T(d). These temporary spare parts are used until a new or repaired part can be installed and then are removed and stored for later emergency installation. X does not use the optional method of accounting for rotable and temporary spare parts in paragraph (e) of this section for any of its rotable or temporary spare parts. The temporary spare parts are materials and supplies under paragraph (c)(1)(i) of this section. Under paragraphs (a)(1) and (a)(3) of this section, the amounts paid for the temporary spare parts are deductible in the taxable year in which they are disposed of by the taxpayer. However, because it is unlikely that the temporary spare parts will be disposed of in the near future, X would prefer to treat the amounts paid for the spare parts as capital expenditures subject to depreciation. X may elect under paragraph (d) of this section not to apply the rule contained in paragraph (a)(1) of this section to each of its temporary spare parts. X makes this election by capitalizing the amounts paid for each spare part in the taxable year that X acquires the spare parts and by beginning to recover the costs of each part on its timely filed Federal income tax return for the taxable year in which the part is placed in service for purposes of determining depreciation under the applicable provisions of the Internal Revenue Code and the regulations thereunder. See § 1.263(a)–2T(h) for the treatment of capital expenditures and section 263A for the requirement to capitalize the direct and allocable indirect costs of property produced or property acquired for resale.

Example 14. Election to apply de minimis rule. X provides consulting services to its customers. X purchases 50 office chairs to be used by its employees. Each office chair is a unit of property that costs $80. Also in the same taxable year, X pays amounts to purchase 50 customized briefcases. Assume each briefcase is a unit of property under § 1.263(a)–3T(e), costs $120, and has an economic useful life of 12 months or less, beginning when used and consumed. X has an applicable financial statement (as defined in § 1.263(a)–2T(g)(6)), and X has a written policy at the beginning of the taxable year to expense amounts paid for units of property costing less than $300. The briefcases and the office chairs are materials and supplies under paragraph (c)(1)(iii) and (c)(1)(iv), respectively, of this section. Under paragraph (a)(1) of this section, the amounts paid for the office chairs and briefcases are deductible in the taxable year in which they are used or consumed. However, assuming X meets all the requirements of § 1.263(a)–2T(g), X may elect under paragraph (f) of this section to apply the de minimis rule under § 1.263(a)–2T(g) to amounts paid for the office chairs and briefcases, rather than treat these amounts as the costs of materials and supplies under § 1.162–3T.

(h) *Accounting method changes.* Except as otherwise provided in this section, a change to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481, and the regulations thereunder, apply. A taxpayer seeking to change to a method of accounting permitted in this section must secure the consent of the Commissioner in accordance with § 1.446–1(e) and follow the administrative procedures issued under § 1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to change its accounting method.

(i) *Effective/applicability date.* This section generally applies to amounts paid or incurred (to acquire or produce property) in taxable years beginning on or after January 1, 2012. However, a taxpayer may apply § 1.162–3(e) (the optional method of accounting for rotable and temporary spare parts) to taxable years beginning on or after January 1, 2012. For the applicability of regulations to taxable years beginning before January 1, 2012, see § 1.162–3 in effect prior to January 1, 2012 (§ 1.162–3 as contained in 26 CFR part 1 edition revised as of April 1, 2011).

(j) *Expiration date.* The applicability of this section expires on December 23, 2014.

■ **Par. 4.** Section 1.162–4 is revised to read as follows:

§ 1.162–4 Repairs.

(a) through (d) [Reserved]. For further guidance, see § 1.162–4T(a) through (d).

■ **Par. 5.** Section 1.162–4T is added to read as follows:

§ 1.162–4T Repairs (temporary).

(a) *In general.* A taxpayer may deduct amounts paid for repairs and maintenance to tangible property if the amounts paid are not otherwise required to be capitalized.

(b) *Accounting method changes.* Except as otherwise provided in this section, a change to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481, and the regulations thereunder, apply. A taxpayer seeking to change to a method of accounting permitted in this section must secure the consent of the Commissioner in accordance with § 1.446–1(e) and follow the administrative procedures issued under § 1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to change its accounting method.

(c) *Effective/applicability date.* This section applies to taxable years beginning on or after January 1, 2012. For the applicability of regulations to taxable years beginning before January 1, 2012, see § 1.162–4 in effect prior to January 1, 2012 (§ 1.162–4 as contained in 26 CFR part 1 edition revised as of April 1, 2011).

(d) *Expiration date.* The applicability of this section expires on December 23, 2014

§ 1.162–6 [Removed]

■ **Par. 6.** Section 1.162–6 is removed.

■ **Par. 7.** Section 1.162–11 is amended by revising paragraph (b), and adding paragraphs (c) and (d) to read as follows:

§ 1.162–11 Rentals.

* * * * *

(b) [Reserved]. For further guidance, see § 1.162–11T(b).

(c) [Reserved]. For further guidance, see § 1.162–11T(c).

(d) [Reserved]. For further guidance, see § 1.162–11T(d).

■ **Par. 8.** Section 1.162–11T is added to read as follows:

§ 1.162–11T Rentals (temporary).

(a) [Reserved]. For further guidance, see § 1.162–11(a).

(b) *Improvements by lessee on lessor's property.* The cost to a taxpayer of erecting buildings or making permanent improvements on property of which the taxpayer is a lessee is a capital expenditure and is not deductible as a business expense. For the rules regarding improvements to leased property where the improvements are tangible property, see § 1.263(a)–3T(f)(1). For the rules regarding depreciation or amortization deductions for leasehold improvements, see § 1.167(a)–4T.

(c) *Effective/applicability date.* This section applies to taxable years beginning on or after January 1, 2012. For the applicability of regulations to taxable years beginning before January 1, 2012, see § 1.162–11 in effect prior to January 1, 2012 (§ 1.162–11 as contained in 26 CFR part 1 edition revised as of April 1, 2011).

(d) *Expiration date.* The applicability of this section expires on December 23, 2014.

■ **Par. 9.** Section 1.165–2 is amended by revising paragraph (c) and adding paragraphs (d) and (e) to read as follows:

§ 1.165–2 Obsolescence of nondepreciable property.

* * * * *

(c) *Cross references.* [Reserved]. For further guidance, see § 1.165–2T(c).

(d) *Effective/applicability date.* [Reserved]. For further guidance, see § 1.165–2T(d).

(e) *Expiration date.* [Reserved]. For further guidance, see § 1.165–2T(e).

■ **Par. 10.** Section 1.165–2T is added to read as follows:

§ 1.165–2T Obsolescence of nondepreciable property (temporary).

(a) and (b) [Reserved]. For further guidance, see § 1.165–2(a) and (b).

(c) *Cross references.* For the allowance under section 165(a) of losses arising from the permanent withdrawal of depreciable property from use in the trade or business or in the production of income, see § 1.167(a)–8T, § 1.168(i)–1T, or § 1.168(i)–8T, as applicable. For provisions respecting the obsolescence of depreciable property for which depreciation is determined under section 167 (but not under section 168, section 1400I, section 1400L(c), section 168 prior to its amendment by the Tax Reform Act of 1986 (100 Stat. 2121), or under an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k) through (n), 1400L(b), or 1400N(d))), see § 1.167(a)–9. For the allowance of casualty losses, see § 1.165–7.

(d) *Effective/applicability date.* This section applies to taxable years beginning on or after January 1, 2012. For the applicability of regulations to taxable years beginning before January 1, 2012, see § 1.165–2 in effect prior to January 1, 2012 (§ 1.165–2 as contained in 26 CFR part 1 edition revised as of April 1, 2011).

(e) *Expiration date.* The applicability of this section expires on December 23, 2014.

■ **Par. 11.** Section 1.167(a)–4 is revised to read as follows:

§ 1.167(a)–4 Leased property.

(a) *In general.* [Reserved]. For further guidance, see § 1.167(a)–4T(a).

(b) *Effective/applicability date.* [Reserved]. For further guidance, see § 1.167(a)–4T(b).

■ **Par. 12.** Section 1.167(a)–4T is added to read as follows:

§ 1.167(a)–4T Leased property (temporary).

(a) *In general.* Capital expenditures made by either a lessee or lessor for the erection of a building or for other permanent improvements on leased property are recovered by the lessee or lessor under the provisions of the Internal Revenue Code applicable to the cost recovery of the building or improvements, if subject to depreciation or amortization, without regard to the period of the lease. For example, if the building or improvement is property to which section 168 applies, the lessee or lessor determines the depreciation deduction for the building or improvement under section 168. *See* section 168(i)(8)(A). If the improvement is property to which section 167 or section 197 applies, the lessee or lessor determines the depreciation or amortization deduction for the improvement under section 167 or section 197, as applicable.

(b) *Effective/applicability date*—(1) *In general.* Except as provided in paragraphs (b)(2) and (b)(3) of this section, this section applies to taxable years beginning on or after January 1, 2012.

(2) *Application of this section to leasehold improvements placed in service after December 31, 1986, in taxable years beginning before January 1, 2012.* For leasehold improvements placed in service after December 31, 1986, in taxable years beginning before January 1, 2012, a taxpayer may—

(i) Apply the provisions of this section; or

(ii) Depreciate any leasehold improvement to which section 168 applies under the provisions of section 168 and depreciate or amortize any leasehold improvement to which section 168 does not apply under the provisions of the Internal Revenue Code that are applicable to the cost recovery of that leasehold improvement, without regard to the period of the lease.

(3) *Application of this section to leasehold improvements placed in service before January 1, 1987.* For leasehold improvements placed in service before January 1, 1987, see § 1.167(a)–4 in effect prior to January 1, 2012 (§ 1.167(a)–4 as contained in 26 CFR part 1 edition revised as of April 1, 2011).

(4) *Change in method of accounting.* Except as provided in § 1.446–1(e)(2)(ii)(*d*)(*3*)(*i*), a change to comply with this section for depreciable assets placed in service in a taxable year ending on or after December 30, 2003, is a change in method of accounting to which the provisions of section 446(e) and the regulations under section 446(e) apply. Except as provided in § 1.446–1(e)(2)(ii)(*d*)(*3*)(*i*), a taxpayer also may treat a change to comply with this section for depreciable assets placed in service in a taxable year ending before December 30, 2003, as a change in method of accounting to which the provisions of section 446(e) and the regulations under section 446(e) apply.

(5) *Expiration date.* The applicability of this section expires on December 23, 2014.

■ **Par. 13.** Section 1.167(a)–7 is amended by adding paragraphs (e), (f), and (g) to read as follows:

§ 1.167(a)–7 Accounting for depreciable property.

* * * * *

(e) *Applicability.* [Reserved]. For further guidance, see § 1.167(a)–7T(e).

(f) *Effective/applicability date.* [Reserved]. For further guidance, see § 1.167(a)–7T(f).

(g) *Expiration date.* [Reserved]. For further guidance, see § 1.167(a)–7T(g).

■ **Par. 14.** Section 1.167(a)–7T is added to read as follows:

§ 1.167(a)–7T Accounting for depreciable property (temporary).

(a) through (d) [Reserved]. For further guidance, see § 1.167(a)–7(a) through (d).

(e) *Applicability.* Paragraphs (a), (b), and (d) of this section apply to property for which depreciation is determined under section 167 (but not under section 168, section 1400I, section 1400L(c), section 168 prior to its amendment by the Tax Reform Act of 1986 (100 Stat. 2121), or under an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k) through (n), 1400L(b), or 1400N(d))). Paragraph (c) of this section does not apply to general asset accounts as provided by section 168(i)(4) and § 1.168(i)–1T.

(f) *Effective/applicability date.* This section applies to taxable years beginning on or after January 1, 2012. For the applicability of regulations to taxable years beginning before January 1, 2012, see § 1.167(a)–7 in effect prior to January 1, 2012 (§ 1.167(a)–7 as contained in 26 CFR part 1 edition revised as of April 1, 2011).

(g) *Expiration date.* The applicability of this section expires on December 23, 2014.

■ **Par. 15.** Section 1.167(a)–8 is amended by adding paragraphs (g), (h), and (i) to read as follows:

§ 1.167(a)–8 Retirements.

* * * * *

(g) *Applicability.* [Reserved]. For further guidance, see § 1.167(a)–8T(g).

(h) *Effective/applicability date.* [Reserved]. For further guidance, see § 1.167(a)–8T(h).

(i) [Reserved]. For further guidance, see § 1.167(a)–8T(i).

■ **Par. 16.** Section 1.167(a)–8T is added to read as follows:

§ 1.167(a)–8T Retirements (temporary).

(a) through (f) [Reserved]. For further guidance, see § 1.167(a)–8(a) through (f).

(g) *Applicability.* This section applies to property for which depreciation is determined under section 167 (but not under section 168, section 1400I, section 1400L(c), section 168 prior to its amendment by the Tax Reform Act of 1986 (100 Stat. 2121), or under an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k) through (n), 1400L(b), or 1400N(d))).

(h) *Effective/applicability date.* This section applies to taxable years beginning on or after January 1, 2012. For the applicability of regulations to taxable years beginning before January 1, 2012, see § 1.167(a)–8 in effect prior to January 1, 2012 (§ 1.167(a)–8 as contained in 26 CFR part 1 edition revised as of April 1, 2011).

(i) *Expiration date.* The applicability of this section expires on December 23, 2014.

■ **Par. 17.** Section 1.168(i)–0 is amended by:

■ 1. Adding entries for paragraphs (b)(5) and (b)(6).

■ 2. Adding entry for paragraph (c)(3).

■ 3. Redesignating the entry for paragraph (d)(2) as (d)(4) and adding new entries for paragraphs (d)(2) and (d)(3).

■ 4. Redesignating the entry for paragraph (e)(2)(v) as the entry for paragraph (e)(2)(ix).
■ 5. Adding entries for paragraphs (e)(2)(v), (vi), (vii), (viii).
■ 6. Redesignating paragraph (e)(3)(vi) as (e)(3)(vii) and adding a new paragraph (e)(3)(vi).
■ 7. Redesignating the entry for paragraph (h)(2) as (h)(3), and adding a new paragraph (h)(2).
■ 8. Redesignating the entry for paragraph (i) as (j) and adding a new paragraph (i).
■ 9. Redesignating the entry for paragraph (j) as (k).
■ 10. Redesignating the entries for paragraphs (k), (k)(1), (k)(2), and (k)(3) as (l), (l)(1), (l)(2), and (l)(3) respectively and
■ 11. Redesignating paragraph (l) as paragraph (m).

§ 1.168(i)–0 Table of contents for the general asset account rules.

* * * * *

§ 1.168(i)–1 General asset accounts.

* * * * *

(b) * * *

(5) and (6) [Reserved]. For further guidance, see the entries for § 1.168(i)–1T(b)(5) and (6).

(c) * * *

(3) [Reserved]. For further guidance, see the entry for § 1.168(i)–1T(c)(3).

* * * * *

(d)(2) and (3) [Reserved]. For further guidance, see the entries for § 1.168(i)–1T(d)(2) and (3).

* * * * *

(e)(2) * * *

(v) through (viii) [Reserved]. For further guidance, see the entries for § 1.168(i)–1T(e)(2)(v) through (viii).

* * * * *

(e)(3) * * *

(vi) [Reserved]. For further guidance, see the entry for § 1.168(i)–1T(e)(3)(vi).

* * * * *

(h) * * *

(2) [Reserved]. For further guidance, see the entry for § 1.168(i)–1T(h)(2).

* * * * *

(i) [Reserved]. For further guidance, see the entry for § 1.168(i)–1T(i).

* * * * *

(m) [Reserved]. For further guidance, see the entry for § 1.168(i)–1T(m).

■ **Par. 18.** Section 1.168(i)–0T is added to read as follows:

§ 1.168(i)–0T Table of contents for the general asset account rules (temporary).

This section lists the major paragraphs contained in § 1.168(i)–1T.

§ 1.168(i)–1T General asset accounts (temporary).

(a) through (b)(4) [Reserved]. For further guidance, see the entries for § 1.168(i)–1(a) through (b)(4).
(5) Mass assets.
(6) Remaining adjusted depreciable basis of the general asset account.
(c)(1) through (c)(2) [Reserved]. For further guidance, see the entries for § 1.168(i)–1(c)(1) through (c)(2).
(3) Examples.
(d)(1) [Reserved]. For further guidance, see the entry for § 1.168(i)–1(d)(1).
(d)(2) Assets in general asset account are eligible for additional first year depreciation deduction.
(d)(3) No assets in general asset account are eligible for additional first year depreciation deduction.
(d)(4) through (e)(2)(iv) [Reserved]. For further guidance, see the entries for § 1.168(i)–1(d)(4) through (e)(2)(iv).
(v) Manner of disposition.
(vi) Disposition by transfer to a supplies account.
(vii) Leasehold improvements.
(viii) Determination of asset disposed of.
(e)(2)(ix) through (e)(3)(v) [Reserved]. For further guidance, see the entries for § 1.168(i)–1(e)(2)(ix) through (e)(3)(v).
(vi) Technical termination of a partnership.
(e)(3)(vii) through (h)(1) [Reserved]. For further guidance, see the entries for § 1.168(i)–1(e)(3)(vii) through (h)(1).
(h)(2) Business or income-producing use percentage changes.
(h)(3) [Reserved]. For further guidance, see the entry for § 1.168(i)–1(h)(3).
(i) Redetermination of basis.
(j) through (l) [Reserved]. For further guidance, see the entries for § 1.168(i)–1(j) through (l).
(m) Effective/applicability date.

■ **Par. 19.** Section 1.168(i)–1 is amended by:
■ 1. Revising paragraphs (a) through (l)(1); and
■ 2. Adding paragraph (m).
The revisions and additions read as follows:

§ 1.168(i)–1 General asset accounts.

(a) through (l)(1) [Reserved]. For further guidance, see § 1.168(i)–1T(a) through (l)(1).

* * * * *

(m) [Reserved]. For further guidance, see § 1.168(i)–1T(m).

■ **Par. 20.** Section 1.168(i)–1T is added to read as follows:

§ 1.168(i)–1T General asset accounts (temporary).

(a) *Scope.* This section provides rules for general asset accounts under section 168(i)(4). The provisions of this section apply only to assets for which an election has been made under paragraph (l) of this section.

(b) *Definitions.* For purposes of this section, the following definitions apply:

(1) *Unadjusted depreciable basis* has the same meaning given such term in § 1.168(b)–1(a)(3).

(2) *Unadjusted depreciable basis of the general asset account* is the sum of the unadjusted depreciable bases of all assets included in the general asset account.

(3) *Adjusted depreciable basis of the general asset account* is the unadjusted depreciable basis of the general asset account less the adjustments to basis described in section 1016(a)(2) and (3).

(4) *Expensed cost* is the amount of any allowable credit or deduction treated as a deduction allowable for depreciation or amortization for purposes of section 1245 (for example, a credit allowable under section 30 or a deduction allowable under section 179, 179A, or 190). Expensed cost does not include any additional first year depreciation deduction.

(5) *Mass assets* is a mass or group of individual items of depreciable assets—
(i) That are not necessarily homogenous;
(ii) Each of which is minor in value relative to the total value of the mass or group;
(iii) Numerous in quantity;
(iv) Usually accounted for only on a total dollar or quantity basis;
(v) With respect to which separate identification is impracticable; and
(vi) Placed in service in the same taxable year.

(6) *Remaining adjusted depreciable basis of the general asset account* is the unadjusted depreciable basis of the general asset account less the amount of the additional first year depreciation deduction allowed or allowable, whichever is greater, for the general asset account.

(c) *Establishment of general asset accounts*—(1) *Assets eligible for general asset accounts*—(i) *General rules.* Assets that are subject to either the general depreciation system of section 168(a) or the alternative depreciation system of section 168(g) may be accounted for in one or more general asset accounts. An asset is included in a general asset account only to the extent of the asset's unadjusted depreciable basis. However, an asset is not to be included in a general asset account if the asset is used both in a trade or business (or for the production of income) and in a personal activity at any time during the taxable year in which the asset is placed in service by the taxpayer or if the asset is placed in service and disposed of during the same taxable year.

(ii) *Special rules for assets generating foreign source income.* (A) Assets that generate foreign source income, both United States and foreign source income, or combined gross income of a FSC (as defined in former section 922), DISC (as defined in section 992(a)), or possessions corporation (as defined in section 936) and its related supplier, may be included in a general asset account if the requirements of paragraph (c)(2)(i) of this section are satisfied. If, however, the inclusion of these assets in a general asset account results in a substantial distortion of income, the Commissioner may disregard the general asset account election and make any reallocations of income or expense necessary to clearly reflect income.

(B) A general asset account shall be treated as a single asset for purposes of applying the rules in § 1.861–9T(g)(3) (relating to allocation and apportionment of interest expense under the asset method). A general asset account that generates income in more than one grouping of income (statutory and residual) is a multiple category asset (as defined in § 1.861–9T(g)(3)(ii)), and the income yield from the general asset account must be determined by applying the rules for multiple category assets as if the general asset account were a single asset.

(2) *Grouping assets in general asset accounts*—(i) *General rules.* If a taxpayer makes the election under paragraph (l) of this section, assets that are subject to the election are grouped into one or more general asset accounts. Assets that are eligible to be grouped into a single general asset account may be divided into more than one general asset account. Each general asset account must include only assets that—

(A) Have the same applicable depreciation method;

(B) Have the same applicable recovery period;

(C) Have the same applicable convention; and

(D) Are placed in service by the taxpayer in the same taxable year.

(ii) *Special rules.* In addition to the general rules in paragraph (c)(2)(i) of this section, the following rules apply when establishing general asset accounts—

(A) Assets subject to the mid-quarter convention may only be grouped into a general asset account with assets that are placed in service in the same quarter of the taxable year;

(B) Assets subject to the mid-month convention may only be grouped into a general asset account with assets that are placed in service in the same month of the taxable year;

(C) Passenger automobiles for which the depreciation allowance is limited under section 280F(a) must be grouped into a separate general asset account;

(D) Assets not eligible for any additional first year depreciation deduction (including assets for which the taxpayer elected not to deduct the additional first year depreciation) provided by, for example, section 168(k) through (n), 1400L(b), or 1400N(d), must be grouped into a separate general asset account;

(E) Assets eligible for the additional first year depreciation deduction may only be grouped into a general asset account with assets for which the taxpayer claimed the same percentage of the additional first year depreciation (for example, 30 percent, 50 percent, or 100 percent);

(F) Except for passenger automobiles described in paragraph (c)(2)(ii)(C) of this section, listed property (as defined in section 280F(d)(4)) must be grouped into a separate general asset account;

(G) Assets for which the depreciation allowance for the placed-in-service year is not determined by using an optional depreciation table (for further guidance, see section 8 of Rev. Proc. 87–57, 1987–2 CB 687, 693 (see § 601.601(d)(2) of this chapter)) must be grouped into a separate general asset account;

(H) Mass assets that are or will be subject to paragraph (j)(2)(iii) of this section (disposed of or converted mass asset is identified by a mortality dispersion table) must be grouped into a separate general asset account; and

(I) Assets subject to paragraph (h)(3)(iii)(A) of this section (change in use results in a shorter recovery period or a more accelerated depreciation method) for which the depreciation allowance for the year of change (as defined in § 1.168(i)–4(a)) is not determined by using an optional depreciation table must be grouped into a separate general asset account.

(3) *Examples.* The following examples illustrate the application of this paragraph (c):

Example 1. In 2012, J, a proprietorship with a calendar year-end, purchases and places in service one item of equipment that costs $550,000. This equipment is section 179 property and also is 5-year property under section 168(e). On its Federal income tax return for 2012, J makes an election under section 179 to expense $500,000 of the equipment's cost and makes an election under paragraph (l) of this section to include the equipment in a general asset account. As a result, the unadjusted depreciable basis of the equipment is $50,000. In accordance with paragraph (c)(1) of this section, J must include only $50,000 of the equipment's cost in the general asset account.

Example 2. The facts are the same as in *Example 1,* except that J also places in service 99 other items of equipment in 2012. On its Federal income tax return for 2012, J does not make an election under section 179 to expense the cost of any of the 100 items of equipment and does make an election under paragraph (l) of this section to include the 100 items of equipment in a general asset account. All of the 100 items of equipment placed in service in 2012 are 5-year property under section 168(e), are not listed property, and are not eligible for any additional first year depreciation deduction. J depreciates its 5-year property placed in service in 2012 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. In accordance with paragraph (c)(2) of this section, J includes all of the 100 items of equipment in one general asset account.

Example 3. The facts are the same as in *Example 2,* except that J decides not to include all of the 100 items of equipment in one general asset account. Instead and in accordance with paragraph (c)(2) of this section, J establishes 100 general asset accounts and includes one item of equipment in each general asset account.

Example 4. K, a calendar-year corporation, is a wholesale distributer. In 2012, K places in service the following properties for use in its wholesale distribution business: computers, automobiles, and forklifts. On its federal income tax return for 2012, K does not make an election under section 179 to expense the cost of any of these items of equipment and does make an election under paragraph (l) of this section to include all of these items of equipment in a general asset account. All of these items are 5-year property under section 168(e) and are not eligible for any additional first year depreciation deduction. The computers are listed property, and the automobiles are listed property and are subject to section 280F(a). K depreciates its 5-year property placed in service in 2012 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. Although the computers, automobiles, and forklifts are 5-year property, K cannot include all of them in one general asset account because the computers and automobiles are listed property. Further, even though the computers and automobiles are listed property, K cannot include them in one general asset account because the automobiles also are subject to section 280F(a). In accordance with paragraph (c)(2) of this section, K establishes three general asset accounts: One for the computers, one for the automobiles, and one for the forklifts.

Example 5. L, a fiscal-year corporation with a taxable year ending June 30, purchases and places in service ten items of new equipment in October 2011, and purchases and places in service five other items of new equipment in February 2012. On its federal income tax return for the taxable year ending

June 30, 2012, L does not make an election under section 179 to expense the cost of any of these items of equipment and does make an election under paragraph (l) of this section to include all of these items of equipment in a general asset account. All of these items of equipment are 7-year property under section 168(e), are not listed property, and are not property described in section 168(k)(2)(B) or (C). All of the ten items of equipment placed in service in October 2011 are eligible for the 100-percent additional first year depreciation deduction provided by section 168(k)(5). All of the five items of equipment placed in service in February 2012 are eligible for the 50-percent additional first year depreciation deduction provided by section 168(k)(1). L depreciates its 7-year property placed in service for the taxable year ending June 30, 2012, using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 7-year recovery period, and the half-year convention. Although the 15 items of equipment are depreciated using the same depreciation method, recovery period, and convention, L cannot include all of them in one general asset account because they are eligible for different percentages of the additional first year depreciation deduction. In accordance with paragraph (c)(2) of this section, L establishes two general asset accounts: one for the ten items of equipment eligible for the 100-percent additional first year depreciation deduction, and one for the five items of equipment eligible for the 50-percent additional first year depreciation deduction.

(d) *Determination of depreciation allowance*—(1) *In general.* Depreciation allowances are determined for each general asset account. The depreciation allowances must be recorded in a depreciation reserve account for each general asset account. The allowance for depreciation under this section constitutes the amount of depreciation allowable under section 167(a).

(2) *Assets in general asset account are eligible for additional first year depreciation deduction.* If all the assets in a general asset account are eligible for the additional first year depreciation deduction, the taxpayer first must determine the allowable additional first year depreciation deduction for the general asset account for the placed-in-service year and then must determine the amount otherwise allowable as a depreciation deduction for the general asset account for the placed-in-service year and any subsequent taxable year. The allowable additional first year depreciation deduction for the general asset account for the placed-in-service year is determined by multiplying the unadjusted depreciable basis of the general asset account by the additional first year depreciation deduction percentage applicable to the assets in the account (for example, 30 percent, 50 percent, or 100 percent). The remaining adjusted depreciable basis of the general asset account then is depreciated using the applicable depreciation method, recovery period, and convention for the assets in the account.

(3) *No assets in general asset account are eligible for additional first year depreciation deduction.* If none of the assets in a general asset account are eligible for the additional first year depreciation deduction, the taxpayer must determine the allowable depreciation deduction for the general asset account for the placed-in-service year and any subsequent taxable year by using the applicable depreciation method, recovery period, and convention for the assets in the account.

(4) *Special rule for passenger automobiles.* For purposes of applying section 280F(a), the depreciation allowance for a general asset account established for passenger automobiles is limited for each taxable year to the amount prescribed in section 280F(a) multiplied by the excess of the number of automobiles originally included in the account over the number of automobiles disposed of during the taxable year or in any prior taxable year in a transaction described in paragraphs (e)(3)(iii) (disposition of an asset in a qualifying disposition), (e)(3)(iv) (transactions subject to section 168(i)(7)), (e)(3)(v) (transactions subject to section 1031 or 1033), (e)(3)(vi) (technical termination of a partnership), (e)(3)(vii) (anti-abuse rule), (g) (assets subject to recapture), (h)(1) (conversion to personal use), or (h)(2) (business or income-producing use percentage changes) of this section.

(e) *Disposition of an asset from a general asset account*—(1) *Scope.* This paragraph (e) provides rules applicable to dispositions of assets included in a general asset account. For purposes of this paragraph (e), an asset in a general asset account is disposed of when ownership of the asset is transferred or when the asset is permanently withdrawn from use either in the taxpayer's trade or business or in the production of income. A disposition includes the sale, exchange, retirement, physical abandonment, or destruction of an asset. A disposition also occurs when an asset is transferred to a supplies, scrap, or similar account. A disposition also includes the retirement of a structural component (as defined in § 1.48–1(e)(2)) of a building (as defined in § 1.48–1(e)(1)).

(2) *General rules for a disposition*—(i) *No immediate recovery of basis.* Except as provided in paragraph (e)(3) of this section, immediately before a disposition of any asset in a general asset account, the asset is treated as having an adjusted depreciable basis (as defined in § 1.168(b)–1(a)(4)) of zero for purposes of section 1011. Therefore, no loss is realized upon the disposition of an asset from the general asset account. Similarly, where an asset is disposed of by transfer to a supplies, scrap, or similar account, the basis of the asset in the supplies, scrap, or similar account will be zero.

(ii) *Treatment of amount realized.* Any amount realized on a disposition is recognized as ordinary income (notwithstanding any other provision of subtitle A of the Internal Revenue Code) to the extent the sum of the unadjusted depreciable basis of the general asset account and any expensed cost (as defined in paragraph (b)(4) of this section) for assets in the account exceeds any amounts previously recognized as ordinary income upon the disposition of other assets in the account. The recognition and character of any excess amount realized are determined under other applicable provisions of the Internal Revenue Code (other than sections 1245 and 1250 or provisions of the Internal Revenue Code that treat gain on a disposition as subject to section 1245 or 1250).

(iii) *Effect of disposition on a general asset account.* The unadjusted depreciable basis and the depreciation reserve of the general asset account are not affected as a result of a disposition of an asset from the general asset account.

(iv) *Coordination with nonrecognition provisions.* For purposes of determining the basis of an asset acquired in a transaction, other than a transaction described in paragraphs (e)(3)(iv) (pertaining to transactions subject to section 168(i)(7)), (e)(3)(v) (pertaining to transactions subject to section 1031 or 1033), and (e)(3)(vi) (pertaining to technical terminations of partnerships) of this section, to which a nonrecognition section of the Internal Revenue Code applies (determined without regard to this section), the amount of ordinary income recognized under this paragraph (e)(2) is treated as the amount of gain recognized on the disposition.

(v) *Manner of disposition.* The manner of disposition of an asset in a general asset account (for example, normal retirement, abnormal retirement, ordinary retirement, or extraordinary retirement) is not taken into account in determining whether a disposition occurs or gain or loss is recognized.

(vi) *Disposition by transfer to a supplies account.* If a taxpayer made an election under § 1.162–3T(d) to treat the cost of any material and supply as a capital expenditure subject to the allowance for depreciation and also made an election under paragraph (l) of this section to include that material and supply in a general asset account, the taxpayer can dispose of the material and supply by transferring it to a supplies account only if the taxpayer has obtained the consent of the Commissioner to revoke the § 1.162–3T(d) election. See § 1.162–3T(d)(3) for the procedures for revoking a § 1.162–3T(d) election.

(vii) *Leasehold improvements.* The rules of paragraph (e) of this section also apply to—

(A) A lessor of leased property that made an improvement to that property for the lessee of the property, has a depreciable basis in the improvement, made an election under paragraph (l) of this section to include the improvement in a general asset account, and disposes of the improvement before or upon the termination of the lease with the lessee. *See* section 168(i)(8)(B); and

(B) A lessee of leased property that made an improvement to that property, has a depreciable basis in the improvement, made an election under paragraph (l) of this section to include the improvement in a general asset account, and disposes of the improvement before or upon the termination of the lease.

(viii) *Determination of asset disposed of*—(A) *In general.* For purposes of applying paragraph (e) of this section to the disposition of an asset in a general asset account (instead of the disposition of the general asset account), the facts and circumstances of each disposition are considered in determining what is the appropriate asset disposed of. Except as provided in paragraph (e)(2)(viii)(B) of this section, the asset cannot be larger than the unit of property as determined under § 1.263(a)–3T(e)(2), (e)(3), and (e)(5) or as otherwise determined in published guidance in the **Federal Register** or in the Internal Revenue Bulletin (see, for example, Rev. Proc. 2011–38, 2011–18 IRB 743, for units of property for wireless network assets (see § 601.601(d)(2)(ii)(*b*) of this chapter)).

(B) *Exceptions.* For purposes of applying paragraph (e) of this section to the disposition of an asset in a general asset account (instead of the disposition of the general asset account):

(*1*) Each building (not including its structural components) is the asset except as provided in § 1.1250–1(a)(2)(ii) or in paragraph (e)(2)(viii)(B)(*2*) or (*5*) of this section.

(*2*) If a building has two or more condominium or cooperative units, each condominium or cooperative unit (not including its structural components) is the asset except as provided in § 1.1250–1(a)(2)(ii) or in paragraph (e)(2)(viii)(B)(*5*) of this section.

(*3*) Each structural component (including all components thereof) of a building, condominium unit, or cooperative unit is the asset.

(*4*) If a taxpayer properly includes an item in one of the asset classes 00.11 through 00.4 of Rev. Proc. 87–56 (1987–2 CB 674) (see § 601.601(d)(2)(ii)(*b*) of this chapter) or properly classifies an item in one of the categories under section 168(e)(3) (except for a category that includes buildings or structural components; for example, retail motor fuels outlet, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property), each item is the asset provided it is not larger than the unit of property as determined under § 1.263(a)–3T(e)(3) or (e)(5) or as otherwise determined in published guidance in the **Federal Register** or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter), or provided paragraph (e)(2)(viii)(B)(*5*) of this section does not apply to the item. For example, each desk is the asset, each computer is the asset, and each qualified smart electric meter is the asset (assuming these assets are not larger than the unit of property as determined under § 1.263(a)–3T(e)(3) or (e)(5) or as otherwise determined in published guidance in the **Federal Register** or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter)).

(*5*) If the taxpayer places in service an improvement or addition to an asset after the taxpayer placed the asset in service, the improvement or addition is a separate asset provided it is not larger than the unit of property as determined under § 1.263(a)–3T(e)(3) or (e)(5) or as otherwise determined in published guidance in the **Federal Register** or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter).

(*6*) If an asset is not described in one of the asset classes 00.11 through 00.4 of Rev. Proc. 87–56 (1987–2 CB 674) (see § 601.601(d)(2)(ii)(*b*) of this chapter) or in one of the categories under section 168(e)(3), a taxpayer also may use any reasonable, consistent method to treat each of the asset's components as the asset.

(ix) *Examples.* The following examples illustrate the application of this paragraph (e)(2):

Example 1. A, a calendar-year partnership, maintains one general asset account for one office building that cost $10 million. A discovers a leak in the roof of this building and, after consulting with a contractor, decides to replace the entire roof. The retirement of the roof, which is a structural component of the building, is a disposition under paragraph (e)(1) of this section. However, this roof has an unadjusted depreciable basis of zero pursuant to paragraph (e)(2)(i) of this section. Accordingly, A does not recognize any loss upon the retirement of the roof. Instead, the unadjusted depreciable basis of the general asset account for the office building is not affected by the retirement of the roof and, as a result, A continues to depreciate the $10 million cost of this general asset account.

Example 2. B, a calendar-year commercial airline company, maintains one general asset account for five aircrafts that cost a total of $500 million. B replaces the existing engines on one of the aircrafts with new engines and treats each engine of an aircraft as a major component of the aircraft. Assume each aircraft is a unit of property as determined under § 1.263(a)–3T(e)(3). However, for disposition purposes of general asset accounts, B consistently treats each major component of an aircraft as the asset. Thus, the retirement of these replaced engines is a disposition under paragraph (e)(1) of this section. However, the engines have an unadjusted depreciable basis of zero pursuant to paragraph (e)(2)(i) of this section. Accordingly, B does not recognize any loss upon the retirement of the engines. Instead, the unadjusted depreciable basis of the general asset account for the five aircrafts is not affected by the retirement of the engines and, as a result, B continues to depreciate the $500 million cost of this general asset account.

Example 3. (i) R, a calendar-year corporation, maintains one general asset account for ten machines. The machines cost a total of $10,000 and are placed in service in June 2012. Of the ten machines, one machine costs $8,200 and nine machines cost a total of $1,800. Assume R depreciates this general asset account using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and a half-year convention. R does not make a section 179 election for any of the machines, and all of the machines are not eligible for any additional first year depreciation deduction. As of January 1, 2013, the depreciation reserve of the account is $2,000 [$10,000 x 20 percent].

(ii) On February 8, 2013, R sells the machine that cost $8,200 to an unrelated party for $9,000. Under paragraph (e)(2)(i) of this section, this machine has an adjusted depreciable basis of zero.

(iii) On its 2013 tax return, R recognizes the amount realized of $9,000 as ordinary income because such amount does not exceed the unadjusted depreciable basis of the general asset account ($10,000), plus any expensed cost for assets in the account ($0), less amounts previously recognized as ordinary income ($0). Moreover, the unadjusted depreciable basis and depreciation reserve of the account are not affected by the disposition of the machine. Thus, the depreciation allowance for the account in 2013 is $3,200 ($10,000 x 32 percent).

Example 4. (i) The facts are the same as in *Example 3.* In addition, on June 4, 2014, R sells seven machines to an unrelated party for a total of $1,100. In accordance with paragraph (e)(2)(i) of this section, these machines have an adjusted depreciable basis of zero.

(ii) On its 2014 tax return, R recognizes $1,000 as ordinary income (the unadjusted depreciable basis of $10,000, plus the expensed cost of $0, less the amount of $9,000 previously recognized as ordinary income). The recognition and character of the excess amount realized of $100 ($1,100 − $1,000) are determined under applicable provisions of the Internal Revenue Code other than section 1245 (such as section 1231). Moreover, the unadjusted depreciable basis and depreciation reserve of the account are not affected by the disposition of the machines. Thus, the depreciation allowance for the account in 2014 is $1,920 ($10,000 x 19.2 percent).

(3) *Special rules*—(i) *In general.* This paragraph (e)(3) provides the rules for terminating general asset account treatment upon certain dispositions. While the rules under paragraphs (e)(3)(ii) and (iii) of this section are optional rules, the rules under paragraphs (e)(3)(iv), (v), (vi), and (vii) of this section are mandatory rules. A taxpayer elects to apply paragraph (e)(3)(ii) or (iii) of this section by reporting the gain, loss, or other deduction on the taxpayer's timely filed original Federal income tax return (including extensions) for the taxable year in which the disposition occurs. A taxpayer may revoke the election to apply paragraph (e)(3)(ii) or (iii) of this section only by filing a request for a private letter ruling and obtaining the Commissioner's consent to revoke the election. The Commissioner may grant a request to revoke this election if the taxpayer can demonstrate good cause for the revocation. The election to apply paragraph (e)(3)(ii) or (iii) of this section may not be made or revoked through the filing of an application for change in accounting method. For purposes of applying paragraph (e)(3)(iii) through (vii) of this section, see paragraph (j) of this section for identifying an asset disposed of and its unadjusted depreciable basis.

(ii) *Disposition of all assets remaining in a general asset account*—(A) *Optional termination of a general asset account.* Upon the disposition of all of the assets, or the last asset, in a general asset account, a taxpayer may apply this paragraph (e)(3)(ii) to recover the adjusted depreciable basis of the general asset account (rather than having paragraph (e)(2) of this section apply). Under this paragraph (e)(3)(ii), the general asset account terminates and the amount of gain or loss for the general asset account is determined under section 1001(a) by taking into account the adjusted depreciable basis of the general asset account at the time of the disposition (as determined under the applicable convention for the general asset account). The recognition and character of the gain or loss are determined under other applicable provisions of the Internal Revenue Code, except that the amount of gain subject to section 1245 (or section 1250) is limited to the excess of the depreciation allowed or allowable for the general asset account, including any expensed cost (or the excess of the additional depreciation allowed or allowable for the general asset account), over any amounts previously recognized as ordinary income under paragraph (e)(2) of this section.

(B) *Examples.* The following examples illustrate the application of this paragraph (e)(3)(ii):

Example 1. (i) T, a calendar-year corporation, maintains a general asset account for 1,000 calculators. The calculators cost a total of $60,000 and are placed in service in 2012. Assume T depreciates this general asset account using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and a half-year convention. T does not make a section 179 election for any of the calculators, and all of the calculators are not eligible for any additional first year depreciation deduction. In 2013, T sells 200 of the calculators to an unrelated party for a total of $10,000 and recognizes the $10,000 as ordinary income in accordance with paragraph (e)(2) of this section.

(ii) On March 26, 2014, T sells the remaining calculators in the general asset account to an unrelated party for $35,000. T elects to apply paragraph (e)(3)(ii) of this section. As a result, the account terminates and gain or loss is determined for the account.

(iii) On the date of disposition, the adjusted depreciable basis of the account is $23,040 (unadjusted depreciable basis of $60,000 less the depreciation allowed or allowable of $36,960). Thus, in 2014, T recognizes gain of $11,960 (amount realized of $35,000 less the adjusted depreciable basis of $23,040). The gain of $11,960 is subject to section 1245 to the extent of the depreciation allowed or allowable for the account (plus the expensed cost for assets in the account) less the amounts previously recognized as ordinary income ($36,960 + $0 − $10,000 = $26,960). As a result, the entire gain of $11,960 is subject to section 1245.

Example 2. (i) J, a calendar-year corporation, maintains a general asset account for one item of equipment. This equipment costs $2,000 and is placed in service in 2012. Assume J depreciates this general asset account using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and a half-year convention. J does not make a section 179 election for the equipment, and it is not eligible for any additional first year depreciation deduction. In June 2014, J sells the equipment to an unrelated party for $1,000. J elects to apply paragraph (e)(3)(ii) of this section. As a result, the account terminates and gain or loss is determined for the account.

(iii) On the date of disposition, the adjusted depreciable basis of the account is $768 (unadjusted depreciable basis of $2,000 less the depreciation allowed or allowable of $1,232). Thus, in 2014, J recognizes gain of $232 (amount realized of $1,000 less the adjusted depreciable basis of $768). The gain of $232 is subject to section 1245 to the extent of the depreciation allowed or allowable for the account (plus the expensed cost for assets in the account) less the amounts previously recognized as ordinary income ($1,232 + $0 − $0 = $1,232). As a result, the entire gain of $232 is subject to section 1245.

(iii) *Disposition of an asset in a qualifying disposition*—(A) *Optional determination of the amount of gain, loss, or other deduction.* In the case of a qualifying disposition of an asset (described in paragraph (e)(3)(iii)(B) of this section), a taxpayer may elect to apply this paragraph (e)(3)(iii) (rather than having paragraph (e)(2) of this section apply). Under this paragraph (e)(3)(iii), general asset account treatment for the asset terminates as of the first day of the taxable year in which the qualifying disposition occurs, and the amount of gain, loss, or other deduction for the asset is determined under § 1.168(i)–8T by taking into account the asset's adjusted depreciable basis at the time of the disposition. The adjusted depreciable basis of the asset at the time of the disposition (as determined under the applicable convention for the general asset account in which the asset was included) equals the unadjusted depreciable basis of the asset less the depreciation allowed or allowable for the asset, computed by using the depreciation method, recovery period, and convention applicable to the general asset account in which the asset was included and by including the portion of the additional first year depreciation deduction claimed for the general asset account that is attributable to the asset disposed of. The recognition and character of the gain, loss, or other deduction are determined under other applicable provisions of the Internal Revenue Code, except that the amount of gain subject to section 1245 (or section 1250) is limited to the lesser of—

(*1*) The depreciation allowed or allowable for the asset, including any expensed cost (or the additional depreciation allowed or allowable for the asset); or

(*2*) The excess of—

(*i*) The original unadjusted depreciable basis of the general asset account plus, in the case of section 1245 property originally included in the general asset account, any expensed cost; over

(*ii*) The cumulative amounts of gain previously recognized as ordinary income under either paragraph (e)(2) of this section or section 1245 (or section 1250).

(B) *Qualifying dispositions.* A *qualifying disposition* is a disposition that does not involve all the assets, or the last asset, remaining in a general asset account and that is not described in paragraphs (e)(3)(iv) (pertaining to transactions subject to section 168(i)(7)), (v) (pertaining to transactions subject to section 1031 or 1033), (vi) (pertaining to technical terminations of partnerships), or (vii) (anti-abuse rule) of this section.

(C) *Effect of a qualifying disposition on a general asset account.* If the taxpayer elects to apply this paragraph (e)(3)(iii) to a qualifying disposition of an asset, then—

(*1*) The asset is removed from the general asset account as of the first day of the taxable year in which the qualifying disposition occurs. For that taxable year, the taxpayer accounts for the asset in a single asset account in accordance with the rules under § 1.168(i)–7T(b);

(*2*) The unadjusted depreciable basis of the general asset account is reduced by the unadjusted depreciable basis of the asset as of the first day of the taxable year in which the disposition occurs;

(*3*) The depreciation reserve of the general asset account is reduced by the depreciation allowed or allowable for the asset as of the end of the taxable year immediately preceding the year of disposition, computed by using the depreciation method, recovery period, and convention applicable to the general asset account in which the asset was included and by including the portion of the additional first year depreciation deduction claimed for the general asset account that is attributable to the asset disposed of; and

(*4*) For purposes of determining the amount of gain realized on subsequent dispositions that is subject to ordinary income treatment under paragraph (e)(2)(ii) of this section, the amount of any expensed cost with respect to the asset is disregarded.

(D) *Example.* The following example illustrates the application of this paragraph (e)(3)(iii):

Example. (i) Z, a calendar-year corporation, maintains one general asset account for 12 machines. Each machine costs $15,000 and is placed in service in 2012. Of the 12 machines, nine machines that cost a total of $135,000 are used in Z's Kentucky plant, and three machines that cost a total of $45,000 are used in Z's Ohio plant. Assume Z depreciates this general asset account using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. Z does not make a section 179 election for any of the machines, and all of the machines are not eligible for any additional first year depreciation deduction. As of January 1, 2014, the depreciation reserve for the account is $93,600.

(ii) On May 27, 2014, Z sells its entire manufacturing plant in Ohio to an unrelated party. The sales proceeds allocated to each of the three machines at the Ohio plant is $5,000. Because this transaction is a qualifying disposition under paragraph (e)(3)(iii)(B) of this section, Z elects to apply paragraph (e)(3)(iii) of this section.

(iii) For Z's 2014 return, the depreciation allowance for the account is computed as follows. As of December 31, 2013, the depreciation allowed or allowable for the three machines at the Ohio plant is $23,400. Thus, as of January 1, 2014, the unadjusted depreciable basis of the account is reduced from $180,000 to $135,000 ($180,000 less the unadjusted depreciable basis of $45,000 for the three machines), and the depreciation reserve of the account is decreased from $93,600 to $70,200 ($93,600 less the depreciation allowed or allowable of $23,400 for the three machines as of December 31, 2013). Consequently, the depreciation allowance for the account in 2014 is $25,920 ($135,000 × 19.2 percent).

(iv) For Z's 2014 return, gain or loss for each of the three machines at the Ohio plant is determined as follows. The depreciation allowed or allowable in 2014 for each machine is $1,440 [($15,000 x 19.2 percent)/2]. Thus, the adjusted depreciable basis of each machine under section 1011 is $5,760 (the adjusted depreciable basis of $7,200 removed from the account less the depreciation allowed or allowable of $1,440 in 2014). As a result, the loss recognized in 2014 for each machine is $760 ($5,000 − $5,760), which is subject to section 1231.

(iv) *Transactions subject to section 168(i)(7)*—(A) *In general.* If a taxpayer transfers one or more assets in a general asset account in a transaction described in section 168(i)(7)(B) (pertaining to treatment of transferees in certain nonrecognition transactions), the taxpayer (the transferor) and the transferee must apply this paragraph (e)(3)(iv) to the asset (instead of applying paragraph (e)(2), (e)(3)(ii), or (e)(3)(iii) of this section). The transferee is bound by the transferor's election under paragraph (l) of this section for the portion of the transferee's basis in the asset that does not exceed the transferor's adjusted depreciable basis of the general asset account or the asset, as applicable (as determined under paragraph (e)(3)(iv)(B)(*2*) or (e)(3)(iv)(C)(*2*) of this section, as applicable).

(B) *All assets remaining in general asset account are transferred.* If a taxpayer transfers all the assets, or the last asset, in a general asset account in a transaction described in section 168(i)(7)(B)—

(*1*) The taxpayer (the transferor) must terminate the general asset account on the date of the transfer. The allowable depreciation deduction for the general asset account for the transferor's taxable year in which the section 168(i)(7)(B) transaction occurs is computed by using the depreciation method, recovery period, and convention applicable to the general asset account. This allowable depreciation deduction is allocated between the transferor and the transferee on a monthly basis. This allocation is made in accordance with the rules in § 1.168(d)–1(b)(7)(ii) for allocating the depreciation deduction between the transferor and the transferee;

(*2*) The transferee must establish a new general asset account for all the assets, or the last asset, in the taxable year in which the section 168(i)(7)(B) transaction occurs for the portion of its basis in the assets that does not exceed the transferor's adjusted depreciable basis of the general asset account in which all the assets, or the last asset, were included. The transferor's adjusted depreciable basis of this general asset account is equal to the adjusted depreciable basis of that account as of the beginning of the transferor's taxable year in which the transaction occurs, decreased by the amount of depreciation allocable to the transferor for the year of the transfer (as determined under paragraph (e)(3)(iv)(B)(*1*) of this section). The transferee is treated as the transferor for purposes of computing the allowable depreciation deduction for the new general asset account under section 168. The new general asset account must be established in accordance with the rules in paragraph (c) of this section, except that the unadjusted depreciable bases of all the assets or the last asset, and the greater of the depreciation allowed or allowable for all the assets or the last asset (including the amount of depreciation for the transferred assets that is allocable to the transferor for the year of the transfer), are included in the newly established general asset account. Consequently, this general asset account in the year of the transfer will have a beginning balance for both the unadjusted depreciable basis and the depreciation reserve of the general asset account; and

(*3*) For purposes of section 168 and this section, the transferee treats the portion of its basis in the assets that exceeds the transferor's adjusted depreciable basis of the general asset account in which all the assets, or the last asset, were included (as determined under paragraph (e)(3)(iv)(B)(*2*) of this section) as a separate asset that the transferee placed in service on the date of the transfer. The transferee accounts for this asset under § 1.168(i)–7T or may make an election under paragraph (l) of this section to include the asset in a general asset account.

(C) *Not all assets remaining in general asset account are transferred.* If a taxpayer transfers an asset in a general asset account in a transaction described in section 168(i)(7)(B) and if paragraph (e)(3)(iv)(B) of this section does not apply to this asset—

(*1*) The taxpayer (the transferor) must remove the transferred asset from the general asset account in which the asset is included, as of the first day of the taxable year in which the section 168(i)(7)(B) transaction occurs. In addition, the adjustments to the general asset account described in paragraph (e)(3)(iii)(C)(*2*) through (*4*) of this section must be made. The allowable depreciation deduction for the asset for the transferor's taxable year in which the section 168(i)(7)(B) transaction occurs is computed by using the depreciation method, recovery period, and convention applicable to the general asset account in which the asset was included. This allowable depreciation deduction is allocated between the transferor and the transferee on a monthly basis. This allocation is made in accordance with the rules in § 1.168(d)–1(b)(7)(ii) for allocating the depreciation deduction between the transferor and the transferee;

(*2*) The transferee must establish a new general asset account for the asset in the taxable year in which the section 168(i)(7)(B) transaction occurs for the portion of its basis in the asset that does not exceed the transferor's adjusted depreciable basis of the asset. The transferor's adjusted depreciable basis of this asset is equal to the adjusted depreciable basis of the asset as of the beginning of the transferor's taxable year in which the transaction occurs, decreased by the amount of depreciation allocable to the transferor for the year of the transfer (as determined under paragraph (e)(3)(iv)(C)(*1*) of this section). The transferee is treated as the transferor for purposes of computing the allowable depreciation deduction for the new general asset account under section 168. The new general asset account must be established in accordance with the rules in paragraph (c) of this section, except that the unadjusted depreciable basis of the asset, and the greater of the depreciation allowed or allowable for the asset (including the amount of depreciation for the transferred asset that is allocable to the transferor for the year of the transfer), are included in the newly established general asset account. Consequently, this general asset account in the year of the transfer will have a beginning balance for both the unadjusted depreciable basis and the depreciation reserve of the general asset account; and

(*3*) For purposes of section 168 and this section, the transferee treats the portion of its basis in the asset that exceeds the transferor's adjusted depreciable basis of the asset (as determined under paragraph (e)(3)(iv)(C)(*2*) of this section) as a separate asset that the transferee placed in service on the date of the transfer. The transferee accounts for this asset under § 1.168(i)–7T or may make an election under paragraph (l) of this section to include the asset in a general asset account.

(v) *Transactions subject to section 1031 or section 1033*—(A) *Like-kind exchange or involuntary conversion of all assets remaining in a general asset account.* If all the assets, or the last asset, in a general asset account are transferred by a taxpayer in a like-kind exchange (as defined under § 1.168–6(b)(11)) or in an involuntary conversion (as defined under § 1.168–6(b)(12)), the taxpayer must apply this paragraph (e)(3)(v)(A) (instead of applying paragraph (e)(2), (e)(3)(ii), or (e)(3)(iii) of this section). Under this paragraph (e)(3)(v)(A), the general asset account terminates as of the first day of the year of disposition (as defined in § 1.168(i)–6(b)(5)) and—

(*1*) The amount of gain or loss for the general asset account is determined under section 1001(a) by taking into account the adjusted depreciable basis of the general asset account at the time of disposition (as defined in § 1.168(i)–6(b)(3)). The depreciation allowance for the general asset account in the year of disposition is determined in the same manner as the depreciation allowance for the relinquished MACRS property (as defined in § 1.168(i)–6(b)(2)) in the year of disposition is determined under § 1.168(i)–6. The recognition and character of gain or loss are determined in accordance with paragraph (e)(3)(ii)(A) of this section (notwithstanding that paragraph (e)(3)(ii) of this section is an optional rule); and

(*2*) The adjusted depreciable basis of the general asset account at the time of disposition is treated as the adjusted depreciable basis of the relinquished MACRS property.

(B) *Like-kind exchange or involuntary conversion of less than all assets remaining in a general asset account.* If an asset in a general asset account is transferred by a taxpayer in a like-kind exchange or in an involuntary conversion and if paragraph (e)(3)(v)(A) of this section does not apply to this asset, the taxpayer must apply this paragraph (e)(3)(v)(B) (instead of applying paragraph (e)(2), (e)(3)(ii), or (e)(3)(iii) of this section). Under this paragraph (e)(3)(v)(B), general asset account treatment for the asset terminates as of the first day of the year of disposition (as defined in § 1.168(i)–6(b)(5)), and—

(*1*) The amount of gain or loss for the asset is determined by taking into account the asset's adjusted depreciable basis at the time of disposition (as defined in § 1.168(i)–6(b)(3)). The adjusted depreciable basis of the asset at the time of disposition equals the unadjusted depreciable basis of the asset less the depreciation allowed or allowable for the asset, computed by using the depreciation method, recovery period, and convention applicable to the general asset account in which the asset was included and by including the portion of the additional first year depreciation deduction claimed for the general asset account that is attributable to the relinquished asset. The depreciation allowance for the asset in the year of disposition is determined in the same manner as the depreciation allowance for the relinquished MACRS property (as defined in § 1.168(i)–6(b)(2)) in the year of disposition is determined under § 1.168(i)–6. The recognition and character of the gain or loss are determined in accordance with paragraph (e)(3)(iii)(A) of this section (notwithstanding that paragraph (e)(3)(iii) of this section is an optional rule); and

(*2*) As of the first day of the year of disposition, the taxpayer must remove the relinquished asset from the general asset account and make the adjustments to the general asset account described in paragraph (e)(3)(iii)(C)(*2*) through (*4*) of this section.

(vi) *Technical termination of a partnership.* In the case of a technical termination of a partnership under section 708(b)(1)(B), the terminated partnership must apply this paragraph (e)(3)(vi) (instead of applying paragraph (e)(2), (e)(3)(ii), or (e)(3)(iii) of this section). Under this paragraph (e)(3)(vi), all of the terminated partnership's general asset accounts terminate as of the date of its termination under section 708(b)(1)(B). The terminated partnership computes the allowable depreciation deduction for each of its general asset accounts for the taxable year in which the technical termination occurs by using the depreciation method, recovery period, and convention applicable to the general asset account. The new partnership is not bound by the terminated partnership's election under paragraph (l) of this section.

(vii) *Anti-abuse rule*—(A) *In general.* If an asset in a general asset account is disposed of by a taxpayer in a transaction described in paragraph (e)(3)(vii)(B) of this section, general asset account treatment for the asset terminates as of the first day of the taxable year in which the disposition occurs. Consequently, the taxpayer must determine the amount of gain, loss, or other deduction attributable to the disposition in the manner described in paragraph (e)(3)(iii)(A) of this section (notwithstanding that paragraph (e)(3)(iii)(A) of this section is an optional rule) and must make the adjustments to the general asset account described in paragraph (e)(3)(iii)(C)(*1*) through (*4*) of this section.

(B) *Abusive transactions.* A transaction is described in this paragraph (e)(3)(vii)(B) if the transaction is not described in paragraph (e)(3)(iv), (e)(3)(v), or (e)(3)(vi) of this section, and if the transaction is entered into, or made, with a principal purpose of achieving a tax benefit or result that would not be available absent an election under this section. Examples of these types of transactions include—

(*1*) A transaction entered into with a principal purpose of shifting income or deductions among taxpayers in a manner that would not be possible absent an election under this section in order to take advantage of differing effective tax rates among the taxpayers; or

(*2*) An election made under this section with a principal purpose of disposing of an asset from a general asset account in order to utilize an expiring net operating loss or credit if the transaction is not a bona fide disposition. The fact that a taxpayer with a net operating loss carryover or a credit carryover transfers an asset to a related person or transfers an asset pursuant to an arrangement where the asset continues to be used (or is available for use) by the taxpayer pursuant to a lease (or otherwise) indicates, absent strong evidence to the contrary, that the transaction is described in this paragraph (e)(3)(vii)(B).

(f) *Assets generating foreign source income*—(1) *In general.* This paragraph (f) provides the rules for determining the source of any income, gain, or loss recognized, and the appropriate section 904(d) separate limitation category or categories for any foreign source income, gain, or loss recognized on a disposition (within the meaning of paragraph (e)(1) of this section) of an asset in a general asset account that consists of assets generating both United States and foreign source income. These rules apply only to a disposition to which paragraphs (e)(2) (general disposition rules), (e)(3)(ii) (disposition of all assets remaining in a general asset account), (e)(3)(iii) (disposition of an asset in a qualifying disposition), (e)(3)(v) (transactions subject to section 1031 or 1033), or (e)(3)(vii) (anti-abuse rule) of this section applies.

(2) *Source of ordinary income, gain, or loss*—(i) *Source determined by allocation and apportionment of depreciation allowed.* The amount of any ordinary income, gain, or loss that is recognized on the disposition of an asset in a general asset account must be apportioned between United States and foreign sources based on the allocation and apportionment of the—

(A) Depreciation allowed for the general asset account as of the end of the taxable year in which the disposition occurs if paragraph (e)(2) of this section applies to the disposition;

(B) Depreciation allowed for the general asset account as of the time of disposition if the taxpayer applies paragraph (e)(3)(ii) of this section to the disposition of all assets, or the last asset, in the general asset account, or if all the assets, or the last asset, in the general asset account are disposed of in a transaction described in paragraph (e)(3)(v)(A) of this section; or

(C) Depreciation allowed for the asset disposed of for only the taxable year in which the disposition occurs if the taxpayer applies paragraph (e)(3)(iii) of this section to the disposition of the asset in a qualifying disposition, if the asset is disposed of in a transaction described in paragraph (e)(3)(v)(B) of this section (like-kind exchange or involuntary conversion), or if the asset is disposed of in a transaction described in paragraph (e)(3)(vii) of this section (anti-abuse rule).

(ii) *Formula for determining foreign source income, gain, or loss.* The amount of ordinary income, gain, or loss recognized on the disposition that shall be treated as foreign source income, gain, or loss must be determined under the formula in this paragraph (f)(2)(ii). For purposes of this formula, the allowed depreciation deductions are determined for the applicable time period provided in paragraph (f)(2)(i) of this section. The formula is:

Foreign Source Income, Gain, or Loss from the Disposition of an Asset. = Total Ordinary Income, Gain, or Loss from the Disposition of an Asset. × Allowed Depreciation Deductions Allocated and Apportioned to Foreign Source Income/Total Allowed Depreciation Deductions for the General Asset Account or for the Asset Disposed of (as applicable).

(3) *Section 904(d) separate categories.* If the assets in the general asset account generate foreign source income in more than one separate category under section 904(d)(1) or another section of the Internal Revenue Code (for example, income treated as foreign source income under section 904(g)(10)), or under a United States income tax treaty that requires the foreign tax credit limitation to be determined separately for specified types of income, the amount of ''foreign source income, gain, or loss from the disposition of an asset'' (as determined under the formula in paragraph (f)(2)(ii) of this section) must be allocated and apportioned to the applicable separate category or categories under the formula in this paragraph (f)(3). For purposes of this formula, the allowed depreciation deductions are determined for the applicable time period provided in paragraph (f)(2)(i) of this section. The formula is:

Foreign Source Income, Gain, or Loss in a Separate Category. = Foreign Source Income, Gain, or Loss from The Disposition of an Asset. × Allowed Depreciation Deductions Allocated and Apportioned to a Separate Category Total/Allowed Depreciation Deductions and Apportioned to Foreign Source Income.

(g) *Assets subject to recapture.* If the basis of an asset in a general asset account is increased as a result of the recapture of any allowable credit or deduction (for example, the basis adjustment for the recapture amount under section 30(d)(2), 50(c)(2), 168(l)(7), 168(n)(4), 179(d)(10), 179A(e)(4), or 1400N(d)(5)), general asset account treatment for the asset terminates as of the first day of the taxable year in which the recapture event occurs. Consequently, the taxpayer must remove the asset from the general asset account as of that day and must make the adjustments to the general asset account described in paragraph (e)(3)(iii)(C)(*2*) through (*4*) of this section.

(h) *Changes in use*—(1) *Conversion to personal use.* An asset in a general asset account becomes ineligible for general asset account treatment if a taxpayer uses the asset in a personal activity during a taxable year. Upon a conversion to personal use, the taxpayer must remove the asset from the general asset account as of the first day of the taxable year in which the change in use occurs (the year of change) and must make the adjustments to the general asset account described in paragraph (e)(3)(iii)(C)(*2*) through (*4*) of this section.

(2) *Business or income-producing use percentage changes.* If, after the placed-in-service year, a taxpayer uses an asset in a general asset account both in a trade or business (or for the production of income) and in a personal activity, general asset account treatment for the asset terminates as of the first day of the taxable year in which the business (or income-producing) use percentage decreases. Consequently, the taxpayer must remove the asset from the general asset account as of that day and must make the adjustments to the general asset account described in paragraph (e)(3)(iii)(C)(*2*) through (*4*) of this section.

(3) *Change in use results in a different recovery period or depreciation method*—(i) *No effect on general asset account election.* A change in the use described in § 1.168(i)–4(d) (change in use results in a different recovery period or depreciation method) of an asset in a general asset account shall not cause or permit the revocation of the election made under this section.

(ii) *Asset is removed from the general asset account.* Upon a change in the use described in § 1.168(i)–4(d), the taxpayer must remove the asset from the general asset account as of the first day of the year of change (as defined in § 1.168(i)–4(a)) and must make the adjustments to the general asset account described in paragraphs (e)(3)(iii)(C)(*2*) through (*4*) of this section. If, however, the result of the change in use is described in § 1.168(i)–4(d)(3) (change in use results in a shorter recovery period or a more accelerated depreciation method) and the taxpayer elects to treat the asset as though the change in use had not occurred pursuant to § 1.168(i)–4(d)(3)(ii), no adjustment is made to the general asset account upon the change in use.

(iii) *New general asset account is established*—(A) *Change in use results in a shorter recovery period or a more accelerated depreciation method.* If the result of the change in use is described in § 1.168(i)–4(d)(3) (change in use results in a shorter recovery period or a more accelerated depreciation method) and adjustments to the general asset account are made pursuant to paragraph (h)(3)(ii) of this section, the taxpayer must establish a new general asset account for the asset in the year of change in accordance with the rules in paragraph (c) of this section, except that the adjusted depreciable basis of the asset as of the first day of the year of change is included in the general asset account. For purposes of paragraph (c)(2) of this section, the applicable depreciation method, recovery period, and convention are determined under § 1.168(i)–4(d)(3)(i).

(B) *Change in use results in a longer recovery period or a slower depreciation method.* If the result of the change in use is described in § 1.168(i)–4(d)(4) (change in use results in a longer recovery period or a slower depreciation method), the taxpayer must establish a separate general asset account for the asset in the year of change in accordance with the rules in paragraph (c) of this section, except that the unadjusted depreciable basis of the asset, and the greater of the depreciation of the asset allowed or allowable in accordance with section 1016(a)(2), as of the first day of the year of change are included in the newly established general asset account. Consequently, this general asset account as of the first day of the year of change will have a beginning balance for both the unadjusted depreciable basis and the depreciation reserve of the general asset account. For purposes of paragraph (c)(2) of this section, the applicable depreciation method, recovery period, and convention are determined under § 1.168(i)–4(d)(4)(ii).

(i) *Redetermination of basis.* If, after the placed-in-service year, the unadjusted depreciable basis of an asset in a general asset account is redetermined due to a transaction other than that described in paragraph (g) of this section (for example, due to contingent purchase price or discharge of indebtedness), the taxpayer's election under paragraph (l) of this section for the asset also applies to the increase or decrease in basis resulting from the redetermination. For the taxable year in which the increase or decrease in basis occurs, the taxpayer must establish a new general asset account for the amount of the increase or decrease in basis in accordance with the rules in paragraph (c) of this section. For purposes of paragraph (c)(2) of this section, the applicable recovery period for the increase or decrease in basis is the recovery period of the asset remaining as of the beginning of the taxable year in which the increase or decrease in basis occurs, the applicable depreciation method and applicable convention for the increase or decrease in basis are the same depreciation method and convention applicable to the asset that applies for the taxable year in which the increase or decrease in basis occurs, and the increase or decrease in basis is deemed to be placed in service in the same taxable year as the asset.

(j) *Identification of disposed of or converted asset*—(1) *In general.* The rules of this paragraph (j) apply when an asset in a general asset account is disposed of or converted in a transaction described in paragraphs (e)(3)(iii) (disposition of an asset in a qualifying disposition), (e)(3)(iv)(B) (transactions subject to section 168(i)(7)), (e)(3)(v)(B) (transactions subject to section 1031 or 1033), (e)(3)(vii) (anti-abuse rule), (g) (assets subject to recapture), (h)(1) (conversion to personal use), or (h)(2) (business or income-producing use percentage changes) of this section.

(2) *Identifying which asset is disposed of or converted.* For purposes of identifying which asset in a general asset account is disposed of or converted, a taxpayer must identify the disposed of or converted asset by using—

(i) The specific identification method of accounting. Under this method of accounting, the taxpayer can determine the particular taxable year in which the disposed of or converted asset was placed in service by the taxpayer;

(ii) A first-in, first-out method of accounting if the taxpayer can readily determine from its records the total dispositions of assets with the same recovery period during the taxable year but the taxpayer cannot readily determine from its records the unadjusted depreciable basis of the disposed of or converted asset. Under this method of accounting, the taxpayer identifies the general asset account with the earliest placed-in-service year that has the same recovery period as the disposed of or converted asset and that has assets at the beginning of the taxable year of the disposition or conversion, and the taxpayer treats the disposed of or converted asset as being from that general asset account. To determine which general asset account has assets at the beginning of the taxable year of the disposition or conversion, the taxpayer reduces the number of assets originally included in the account by the number of assets disposed of or converted in any prior taxable year in a transaction to which this paragraph (j) applies;

(iii) A modified first-in, first-out method of accounting if the taxpayer can readily determine from its records the total dispositions of assets with the same recovery period during the taxable year and the unadjusted depreciable basis of the disposed of or converted asset. Under this method of accounting, the taxpayer identifies the general asset account with the earliest placed-in-service year that has the same recovery period as the disposed of or converted asset and that has assets at the beginning of the taxable year of the disposition or conversion with the same unadjusted depreciable basis as the disposed of or converted asset, and the taxpayer treats the disposed of or converted asset as being from that general asset account. To determine which general asset account has assets at the beginning of the taxable year of the disposition or conversion, the taxpayer reduces the number of assets originally included in the account by the number of assets disposed of or converted in any prior taxable year in a transaction to which this paragraph (j) applies;

(iv) A mortality dispersion table if the asset is a mass asset accounted for in a separate general asset account in accordance with paragraph (c)(2)(ii)(H) of this section and if the taxpayer can readily determine from its records the total dispositions of assets with the same recovery period during the taxable year. The mortality dispersion table must be based upon an acceptable sampling of the taxpayer's actual disposition and conversion experience for mass assets or other acceptable statistical or engineering techniques. To use a mortality dispersion table, the taxpayer must adopt recordkeeping practices consistent with the taxpayer's prior practices and consonant with good accounting and engineering practices; or

(v) Any other method as the Secretary may designate by publication in the **Federal Register** or in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) on or after December 23, 2011. For this purpose, a last-in, first-out method of accounting is not a designated method. Under the last-in, first-out method of accounting, the taxpayer identifies the general asset account with the most recent placed-in-service year that has the same recovery period as the disposed of or converted asset and that has assets at the beginning of the taxable year of the disposition or conversion, and the taxpayer treats the disposed of or converted asset as being from that general asset account. To determine which general asset account has assets at the beginning of the taxable year of the disposition or conversion, the taxpayer reduces the number of assets originally included in the account by the number of assets disposed of or converted in any prior taxable year in a transaction to which this paragraph (j) applies.

(3) *Basis of disposed of or converted asset.* After identifying which asset in a general asset account is disposed of or converted, the taxpayer may use any reasonable method that is consistently applied to all its general asset accounts for purposes of determining the unadjusted depreciable basis of a disposed of or converted asset.

(k) *Effect of adjustments on prior dispositions.* The adjustments to a general asset account under paragraph (e)(3)(iii), (e)(3)(iv), (e)(3)(v), (e)(3)(vii), (g), or (h) of this section have no effect on the recognition and character of prior dispositions subject to paragraph (e)(2) of this section.

(l) *Election*—(1) *Irrevocable election.* If a taxpayer makes an election under this paragraph (l), the taxpayer consents to, and agrees to apply, all of the provisions of this section to the assets included in a general asset account. Except as provided in paragraph (c)(1)(ii)(A), (e)(3), (g), or (h) of this section, an election made under this section is irrevocable and will be binding on the taxpayer for computing taxable income for the taxable year for which the election is made and for all subsequent taxable years. An election under this paragraph (l) is made separately by each person owning an asset to which this section applies (for example, by each member of a consolidated group, at the partnership level (and not by the partner separately), or at the S corporation level (and not by the shareholder separately)).

(2) [Reserved]. For further guidance, see § 1.168(i)–1(l)(2).

(3) [Reserved]. For further guidance, see § 1.168(i)–1(l)(3).

(m) *Effective/applicability date*—(1) *In general.* This section applies to taxable years beginning on or after January 1, 2012. For the applicability of § 1.168(i)–1 in taxable years beginning before January 1, 2012, see § 1.168(i)–1 in effect prior to January 1, 2012 (§ 1.168(i)–1 as contained in 26 CFR part 1 edition revised as of April 1, 2011).

(2) *Change in method of accounting.* A change to comply with this section for depreciable assets placed in service in a taxable year ending on or after December 30, 2003, is a change in method of accounting to which the provisions of section 446(e) and the regulations under section 446(e) apply. A taxpayer also may treat a change to comply with this section for depreciable assets placed in service in a taxable year ending before December 30, 2003, as a change in method of accounting to which the provisions of section 446(e) and the regulations under section 446(e) apply.

(3) The applicability of this section expires on December 23, 2014.

■ **Par. 21.** Section 1.168(i)–7T is added to read as follows:

§ 1.168(i)–7T Accounting for MACRS property (temporary).

(a) *In general.* A taxpayer may account for MACRS property (as defined in § 1.168(b)–1(a)(2)) by treating each individual asset as an account (a ''single asset account'' or an ''item account'') or by combining two or more assets in a single account (a ''multiple asset account'' or a ''pool''). A taxpayer may establish as many accounts for MACRS property as the taxpayer wants. This section does not apply to assets included in general asset accounts. For rules applicable to general asset accounts, see § 1.168(i)–1T.

(b) *Required use of single asset accounts.* A taxpayer must account for an asset in a single asset account if the taxpayer uses the asset both in a trade or business (or for the production of income) and in a personal activity, or if the taxpayer places in service and disposes of the asset during the same taxable year. Also, if general asset account treatment for an asset terminates under § 1.168(i)–1T(c)(1)(ii)(A), (e)(3)(iii), (e)(3)(vii), (g), or (h)(2), the taxpayer must account for the asset in a single asset account beginning in the taxable year in which the general asset account treatment for the asset terminates. If a taxpayer accounts for an asset in a multiple asset account or pool treatment and the taxpayer disposes of the asset, the taxpayer must account for the asset in a single asset account beginning in the taxable year in which the disposition occurs. *See* § 1.168(i)–8T(g)(2)(i). If a taxpayer disposes of a component of a larger asset and the unadjusted depreciable basis of the disposed of component is included in the unadjusted depreciable basis of the larger asset, the taxpayer must account for the component in a single asset account beginning in the taxable year in which the disposition occurs. *See* § 1.168(i)–8T(g)(3)(i).

(c) *Establishment of multiple asset accounts or pools*—(1) *Assets eligible for multiple asset accounts or pools.* Except as provided in paragraph (b) of this section, assets that are subject to either the general depreciation system of section 168(a) or the alternative depreciation system of section 168(g) may be accounted for in one or more multiple asset accounts or pools.

(2) *Grouping assets in multiple asset accounts or pools*—(i) *General rules.* Assets that are eligible to be grouped into a single multiple asset account or pool may be divided into more than one multiple asset account or pool. Each multiple asset account or pool must include only assets that—

(A) Have the same applicable depreciation method;

(B) Have the same applicable recovery period;

(C) Have the same applicable convention; and

(D) Are placed in service by the taxpayer in the same taxable year.

(ii) *Special rules.* In addition to the general rules in paragraph (c)(2)(i) of this section, the following rules apply when establishing multiple asset accounts or pools—

(A) Assets subject to the mid-quarter convention may only be grouped into a multiple asset account or pool with assets that are placed in service in the same quarter of the taxable year;

(B) Assets subject to the mid-month convention may only be grouped into a multiple asset account or pool with assets that are placed in service in the same month of the taxable year;

(C) Passenger automobiles for which the depreciation allowance is limited under section 280F(a) must be grouped into a separate multiple asset account or pool;

(D) Assets not eligible for any additional first year depreciation deduction (including assets for which the taxpayer elected not to deduct the additional first year depreciation) provided by, for example, section 168(k) through (n), 1400L(b), or 1400N(d), must be grouped into a separate multiple asset account or pool;

(E) Assets eligible for the additional first year depreciation deduction may only be grouped into a multiple asset account or pool with assets for which the taxpayer claimed the same percentage of the additional first year depreciation (for example, 30 percent, 50 percent, or 100 percent);

(F) Except for passenger automobiles described in paragraph (c)(2)(ii)(C) of this section, listed property (as defined in section 280F(d)(4)) must be grouped into a separate multiple asset account or pool;

(G) Assets for which the depreciation allowance for the placed-in-service year is not determined by using an optional depreciation table (for further guidance, see section 8 of Rev. Proc. 87–57, 1987–2 CB 687, 693 (see § 601.601(d)(2) of this chapter) must be grouped into a separate multiple asset account or pool; and

(H) Mass assets (as defined in § 1.168(i)–8T(b)(2)) that are or will be subject to § 1.168–8T(f)(2)(ii) (disposed of or converted mass asset is identified by a mortality dispersion table) must be grouped into a separate multiple asset account or pool.

(d) *Cross references.* See § 1.167(a)–7T(c) for the records to be maintained by a taxpayer for each account. In addition, see § 1.168(i)–1T for the records to be maintained by a taxpayer for each general asset account.

(e) *Effective/applicability date*—(1) This section applies to taxable years beginning on or after January 1, 2012.

(2) *Change in method of accounting.* A change to comply with this section for depreciable assets placed in service in a taxable year ending on or after December 30, 2003, is a change in method of accounting to which the provisions of section 446(e) and the regulations under section 446(e) apply. A taxpayer also may treat a change to comply with this section for depreciable assets placed in service in a taxable year ending before December 30, 2003, as a change in method of accounting to which the provisions of section 446(e) and the regulations under section 446(e) apply.

(3) *Expiration date.* The applicability of this section expires on December 23, 2014.

■ **Par. 22.** Section 1.168(i)–8T is added to read as follows:

§ 1.168(i)–8T Dispositions of MACRS property (temporary).

(a) *Scope.* This section provides rules applicable to dispositions of MACRS property (as defined in § 1.168(b)–1(a)(2)) or to depreciable property (as defined in § 1.168(b)–1(a)(1)) that would be MACRS property but for an election made by the taxpayer either to expense all or some of the property's cost under section 179, 179A, 179B, 179C, 179D, or 1400I(a)(1), or any similar provision, or to amortize all or some of the property's cost under section 1400I(a)(2) or any similar provision. Except as provided in § 1.168(i)–1T(e)(iii), this section does not apply to dispositions of assets included in a general asset account. For rules applicable to dispositions of assets included in a general asset account, see § 1.168(i)–1T(e).

(b) *Definitions.* For purposes of this section—

(1) *Disposition* occurs when ownership of the asset is transferred or when the asset is permanently withdrawn from use either in the taxpayer's trade or business or in the production of income. A disposition includes the sale, exchange, retirement, physical abandonment, or destruction of an asset. A disposition also includes the retirement of a structural component (as defined in § 1.48–1(e)(2)) of a building (as defined in § 1.48–1(e)(1)). A disposition also occurs when an asset is transferred to a supplies, scrap, or similar account.

(2) *Mass assets* is a mass or group of individual items of depreciable assets—

(i) That are not necessarily homogenous;

(ii) Each of which is minor in value relative to the total value of the mass or group;

(iii) Numerous in quantity;

(iv) Usually accounted for only on a total dollar or quantity basis;

(v) With respect to which separate identification is impracticable; and

(vi) Placed in service in the same taxable year.

(3) *Unadjusted depreciable basis of the multiple asset account or pool* is the sum of the unadjusted depreciable bases (as defined in § 1.168(b)–1(a)(3)) of all assets included in the multiple asset account or pool.

(c) *Special rules*—(1) *Manner of disposition.* The manner of disposition (for example, normal retirement, abnormal retirement, ordinary retirement, or extraordinary retirement) is not taken into account in determining whether a disposition occurs or gain or loss is recognized.

(2) *Disposition by transfer to a supplies account.* If a taxpayer made an election under § 1.162–3T(d) to treat the cost of any material and supply as a capital expenditure subject to the allowance for depreciation, the taxpayer can dispose of the material and supply by transferring it to a supplies account only if the taxpayer has obtained the consent of the Commissioner to revoke the § 1.162–3T(d) election. *See* § 1.162–3T(d)(3) for the procedures for revoking a § 1.162–3T(d) election.

(3) *Leasehold improvements.* This section also applies to—

(i) A lessor of leased property that made an improvement to that property for the lessee of the property, has a depreciable basis in the improvement, and disposes of the improvement before or upon the termination of the lease with the lessee. *See* section 168(i)(8)(B); and

(ii) A lessee of leased property that made an improvement to that property, has a depreciable basis in the improvement, and disposes of the improvement before or upon the termination of the lease.

(4) *Determination of asset disposed of*—(i) *In general.* For purposes of applying this section, the facts and circumstances of each disposition are considered in determining what is the appropriate asset disposed of. Except as provided in paragraph (c)(4)(ii) of this section, the asset for disposition purposes cannot be larger than the unit of property as determined under § 1.263(a)-3T(e)(2), (e)(3), and (e)(5) or as otherwise determined in published guidance in the **Federal Register** or in the Internal Revenue Bulletin (see, for example, Rev. Proc. 2011–38, 2011–18 IRB 743, for units of property for wireless network assets (see § 601.601(d)(2)(ii)(*b*) of this chapter)).

(ii) *Exceptions.* For purposes of applying this section:

(A) Each building (not including its structural components) is the asset except as provided in § 1.1250–1(a)(2)(ii) or in paragraph (c)(4)(ii)(B) or (E) of this section.

(B) If a building has two or more condominium or cooperative units, each condominium or cooperative unit (not including its structural components) is the asset except as provided in § 1.1250–1(a)(2)(ii) or in paragraph (c)(4)(ii)(E) of this section.

(C) Each structural component (including all components thereof) of a building, condominium unit, or cooperative unit is the asset.

(D) If a taxpayer properly includes an item in one of the asset classes 00.11 through 00.4 of Rev. Proc. 87–56 (1987–2 CB 674) (see § 601.601(d)(2)(ii)(*b*) of this chapter) or properly classifies an item in one of the categories under section 168(e)(3) (except for a category that includes buildings or structural components; for example, retail motor fuels outlet, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property), each item is the asset provided it is not larger than the unit of property as determined under § 1.263(a)–3T(e)(3) or (e)(5) or as otherwise determined in published guidance in the **Federal Register** or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter), or provided paragraph (c)(4)(ii)(E) of this section does not apply to the item. For example, each desk is the asset, each computer is the asset, and each qualified smart electric meter is the asset (assuming these assets are not larger than the unit of property as determined under § 1.263(a)–3T(e)(3) or (e)(5) or as otherwise determined in published guidance in the **Federal Register** or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter)).

(E) If the taxpayer places in service an improvement or addition to an asset after the taxpayer placed the asset in service, the improvement or addition is a separate asset provided it is not larger than the unit of property as determined under § 1.263(a)-3T(e)(3) or (e)(5) or as otherwise determined in published guidance in the **Federal Register** or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter).

(E) If an asset is not described in one of the asset classes 00.11 through 00.4 of Rev. Proc. 87–56 (1987–2 CB 674) (see § 601.601(d)(2)(ii)(*b*) of this chapter) or in one of the categories under section 168(e)(3), a taxpayer also may use any reasonable, consistent method to treat each of the asset's components as the asset.

(d) *Gain or loss on dispositions.* Except as provided by section 280B and § 1.280B–1, the following rules apply when assets within the scope of this section are disposed of during a taxable year:

(1) If an asset is disposed of by sale, exchange, or involuntary conversion, gain or loss must be recognized under the applicable provisions of the Internal Revenue Code.

(2) If an asset is disposed of by physical abandonment, loss must be recognized in the amount of the adjusted depreciable basis (as defined in § 1.168(b)-1(a)(4)) of the asset at the time of the abandonment (taking into account the applicable convention). However, if the abandoned asset is subject to nonrecourse indebtedness, paragraph (d)(1) of this section applies to the asset (instead of this paragraph (d)(2)). For a loss from physical abandonment to qualify for recognition under this paragraph (d)(2), the taxpayer must intend to discard the asset irrevocably so that the taxpayer will neither use the asset again nor retrieve it for sale, exchange, or other disposition.

(3) If an asset is disposed of other than by sale, exchange, involuntary conversion, physical abandonment, or conversion to personal use (as, for example, when the asset is transferred to a supplies or scrap account), gain is not recognized. Loss must be recognized in the amount of the excess of the adjusted depreciable basis of the asset at the time of the disposition (taking into account the applicable convention) over the asset's fair market value at the time of the disposition (taking into account the applicable convention).

(e) *Basis of asset disposed of*—(1) *In general.* The adjusted basis of an asset disposed of for computing gain or loss is its adjusted depreciable basis at the time of the asset's disposition (as determined under the applicable convention for the asset).

(2) *Assets disposed of are in multiple asset accounts or are components.* If the taxpayer accounts for the asset disposed of in a multiple asset account or pool, or the asset disposed of is a component of a larger asset and it is impracticable from the taxpayer's records to determine the unadjusted depreciable basis (as defined in § 1.168(b)-1(a)(3)) of the asset disposed of, the taxpayer may use any reasonable method that is consistently applied to the taxpayer's multiple asset accounts or pools or to the taxpayer's larger assets for purposes of determining the unadjusted depreciable basis of assets disposed of. To determine the adjusted depreciable basis of an asset disposed of in a multiple asset account, the depreciation allowed or allowable for the asset disposed of is computed by using the depreciation method, recovery period, and convention applicable to the multiple asset account or pool in which the asset disposed of was included and by including the additional first year depreciation deduction claimed for the asset disposed of. To determine the adjusted depreciable basis of an asset disposed of that is a component of a larger asset, the depreciation allowed or

allowable for the asset disposed of is computed by using the depreciation method, recovery period, and convention applicable to the larger asset of which the asset disposed of is a component and by including the portion of the additional first year depreciation deduction claimed for the larger asset that is attributable to the asset disposed of.

(f) *Identification of asset disposed of*—(1) *In general.* Except as provided in paragraph (f)(2) of this section, a taxpayer must use the specific identification method of accounting to identify which asset is disposed of by the taxpayer. Under this method of accounting, the taxpayer can determine the particular taxable year in which the asset disposed of was placed in service by the taxpayer.

(2) *Asset disposed of is in a multiple asset account.* If a taxpayer accounts for the asset disposed of in a multiple asset account or pool and the total dispositions of assets with the same recovery period during the taxable year are readily determined from the taxpayer's records but it is impracticable from the taxpayer's records to determine the particular taxable year in which the asset disposed of was placed in service by the taxpayer, the taxpayer may identify the asset disposed of by using—

(i) A first-in, first-out method of accounting if the unadjusted depreciable basis of the asset disposed of cannot be readily determined from the taxpayer's records. Under this method of accounting, the taxpayer identifies the multiple asset account or pool with the earliest placed-in-service year that has the same recovery period as the asset disposed of and that has assets at the beginning of the taxable year of the disposition, and the taxpayer treats the asset disposed of as being from that multiple asset account or pool;

(ii) A modified first-in, first-out method of accounting if the unadjusted depreciable basis of the asset disposed of can be readily determined from the taxpayer's records. Under this method of accounting, the taxpayer identifies the multiple asset account or pool with the earliest placed-in-service year that has the same recovery period as the asset disposed of and that has assets at the beginning of the taxable year of the disposition with the same unadjusted depreciable basis as the asset disposed of, and the taxpayer treats the asset disposed of as being from that multiple asset account or pool;

(iii) A mortality dispersion table if the asset disposed of is a mass asset. The mortality dispersion table must be based upon an acceptable sampling of the taxpayer's actual disposition experience for mass assets or other acceptable statistical or engineering techniques. To use a mortality dispersion table, the taxpayer must adopt recordkeeping practices consistent with the taxpayer's prior practices and consonant with good accounting and engineering practices; or

(iv) Any other method as the Secretary may designate by publication in the **Federal Register** or in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) on or after December 23, 2011. For this purpose, a last-in, first-out method of accounting is not a designated method. Under the last-in, first-out method of accounting, the taxpayer identifies the multiple asset account or pool with the most recent placed-in-service year that has the same recovery period as the asset disposed of and that has assets at the beginning of the taxable year of the disposition, and the taxpayer treats the asset disposed of as being from that multiple asset account or pool.

(g) *Accounting for asset disposed of*—(1) *Depreciation ends.* Depreciation ends for an asset at the time of the asset's disposition (as determined under the applicable convention for the asset). *See* § 1.167(a)–10(b). If the asset disposed of is in a single asset account, the single asset account terminates at the time of the asset's disposition (as determined under the applicable convention for the asset).

(2) *Asset disposed of in a multiple asset account or pool.* If the taxpayer accounts for the asset disposed of in a multiple asset account or pool, then—

(i) As of the first day of the taxable year in which the disposition occurs, the asset disposed of is removed from the multiple asset account or pool and is placed into a single asset account. *See* § 1.168(i)–7T(b);

(ii) The unadjusted depreciable basis of the multiple asset account or pool must be reduced by the unadjusted depreciable basis of the asset disposed of as of the first day of the taxable year in which the disposition occurs. See paragraph (e)(2) of this section for determining the unadjusted depreciable basis of the asset disposed of;

(iii) The depreciation reserve of the multiple asset account or pool must be reduced by the depreciation allowed or allowable for the asset disposed of as of the end of the taxable year immediately preceding the year of disposition, computed by using the depreciation method, recovery period, and convention applicable to the multiple asset account or pool in which the asset disposed of was included and by including the additional first year depreciation deduction claimed for the asset disposed of; and

(iv) In determining the adjusted depreciable basis of the asset disposed of at the time of disposition (taking into account the applicable convention), the depreciation allowed or allowable for the asset disposed of is computed by using the depreciation method, recovery period, and convention applicable to the multiple asset account or pool in which the asset disposed of was included and by including the additional first year depreciation deduction claimed for the asset disposed of.

(3) *Disposed of component of a larger asset.* This paragraph (g)(3) applies only to a taxpayer that uses a reasonable, consistent method to treat each of the asset's components as the asset in accordance with paragraph (c)(4)(E) of this section. If the taxpayer disposes of a component of a larger asset and the unadjusted depreciable basis of the disposed component is included in the unadjusted depreciable basis of the larger asset, then—

(i) As of the first day of the taxable year in which the disposition occurs, the disposed of component is removed from the larger asset and is placed into a single asset account. *See* § 1.168(i)–7T(b);

(ii) The unadjusted depreciable basis of the larger asset must be reduced by the unadjusted depreciable basis of the disposed of component as of the first day of the taxable year in which the disposition occurs. See paragraph (e)(2) of this section for determining the unadjusted depreciable basis of the disposed of component;

(iii) The depreciation reserve of the larger asset must be reduced by the depreciation allowed or allowable for the disposed of component as of the end of the taxable year immediately preceding the year of disposition, computed by using the depreciation method, recovery period, and convention applicable to the larger asset in which the disposed of component was included and by including the portion of the additional first year depreciation deduction claimed for the larger asset that is attributable to the disposed of component; and

(iv) In determining the adjusted depreciable basis of the disposed of component at the time of disposition (taking into account the applicable convention), the depreciation allowed or allowable for the asset disposed of is computed by using the depreciation method, recovery period, and convention applicable to the larger asset in which the disposed of component was included and by including the portion of the additional first year depreciation deduction claimed for the larger asset that is attributable to the disposed of component.

(h) *Examples.* The application of this section is illustrated by the following examples:

Example 1. A owns an office building with four elevators. A decides to replace one of the elevators. The retirement of the replaced elevator, which is a structural component of the building, is a disposition. As a result, depreciation for the retired elevator ceases at the time of its retirement (taking into account the applicable convention). A recognizes a loss upon this retirement.

Example 2. B, a calendar-year commercial airline company, owns several aircrafts that are used in the commercial carrying of passengers. B replaces the existing engines on one of the aircrafts with new engines and treats each engine of an aircraft as a major component of the aircraft. Assume each aircraft is a unit of property as determined under § 1.263(a)–3T(e)(3). However, for tax disposition purposes, B consistently treats each major component of an aircraft as the asset. Thus, the retirement of the replaced engines is a disposition. As a result, depreciation for the retired engines ceases at the time of their retirement (taking into account the applicable convention). B recognizes a loss upon this retirement.

Example 3. The facts are the same as in *Example 2,* except B treats each aircraft as the asset for tax disposition purposes. Assume each aircraft is a unit of property as determined under § 1.263(a)–3T(e)(3). Thus, the replacement of the engines on one of the aircrafts is not a disposition. As a result, depreciation continues for the cost of the aircraft (including the cost of the replaced engines) and B does not recognize a loss upon this replacement.

Example 4. C, a corporation, owns several trucks that are used in its trade or business and described in asset class 00.241 of Rev. Proc. 87–56. C replaces the engine on one of the trucks with a new engine and treats each engine of a truck as a major component of the truck. Assume each truck is a unit of property as determined under § 1.263(a)–3T(e)(3). Because the trucks are described in asset class 00.241 of Rev. Proc. 87–56, C must treat each truck as the asset for tax disposition purposes. Thus, the replacement of the engine on the truck is not a disposition. As a result, depreciation continues for the cost of the truck (including the cost of the replaced engine) and C does not recognize a loss upon this replacement.

Example 5. (i) On July 1, 2009, D, a calendar-year taxpayer, purchased and placed in service a multi-story office building that costs $20,000,000. The cost of each structural component of the building was not separately stated. D accounts for the building in its records as a single asset with a cost of $20,000,000. D depreciates the building as nonresidential real property and uses the optional depreciation table that corresponds with the general depreciation system, the straight-line method, a 39-year recovery period, and the mid-month convention. As of January 1, 2012, the depreciation reserve for the building is $1,261,000.

(ii) On June 30, 2012, D replaces one of the building's elevators. Because D cannot identify the cost of the structural components of the office building from its records, D uses a reasonable method that is consistently applied to all of the structural components of the office building to determine the cost of the elevator. Using this reasonable method, D allocates $150,000 of the $20,000,000 purchase price for the building to the retired elevator. Using the optional depreciation table that corresponds with the general depreciation system, the straight-line method, a 39-year recovery period, and the mid-month convention, the depreciation allowed or allowable for the retired elevator as of December 31, 2011, is $9,457.50.

(iii) For D's 2012 Federal income tax return, loss for the retired elevator is determined as follows. The depreciation allowed or allowable for 2012 for the retired elevator is $1,923 ((unadjusted depreciable basis of $150,000 × depreciation rate of 2.564 percent for 2012) × 6/12). Thus, the adjusted depreciable basis of the retired elevator is $138,619.50 (the adjusted depreciable basis of $140,542.50 removed from the building cost less the depreciation allowed or allowable of $1,923 for 2012). As a result, D recognizes a loss of $138,619.50 for the retired elevator in 2012, which is subject to section 1231.

(iv) For D's 2012 Federal income tax return, the depreciation allowance for the building is computed as follows. As of January 1, 2012, the unadjusted depreciable basis of the building is reduced from $20,000,000 to $19,850,000 ($20,000,000 less the unadjusted depreciable basis of $150,000 for the retired elevator), and the depreciation reserve of the building is reduced from $1,261,000 to $1,251,542.50 ($1,261,000 less the depreciation allowed or allowable of $9,457.50 for the retired elevator as of December 31, 2011). Consequently, the depreciation allowance for the building for 2012 is $508,954 ($19,850,000 × depreciation rate of 2.564 percent for 2012).

Example 6. (i) Since 2003, E, a calendar year taxpayer, has accounted for items of MACRS property that are mass assets in pools. Each pool includes only the mass assets that have the same depreciation method, recovery period, and convention, and are placed in service by E in the same taxable year. None of the pools are general asset accounts under section 168(i)(4) and the regulations under section 168(i)(4). E identifies any dispositions of these mass assets by specific identification.

(ii) During 2012, E sells 10 items of mass assets with a 5-year recovery period each for $100. Under the specific identification method, E identifies these mass assets as being from the pool established by E in 2010 for mass assets with a 5-year recovery period. Assume E depreciates this pool using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. E elected not to deduct the additional first year depreciation provided by section 168(k) for 5-year property placed in service during 2010. As of January 1, 2012, this pool contains 100 similar items of mass assets with a total cost of $25,000 and a total depreciation reserve of $13,000. Thus, E allocates a cost of $250 ($25,000 × (1/100)) to each disposed of mass asset and depreciation allowed or allowable of $130 ($13,000 × (1/100)) to each disposed of mass asset. The depreciation allowed or allowable in 2012 for each disposed of mass asset is $24 [($250 × 19.2 percent)/2]. As a result, the adjusted depreciable basis of each disposed of mass asset under section 1011 is $96 ($250–$130–$24). Thus, E recognizes a gain of $4 for each disposed of mass asset in 2012, which is subject to section 1245.

(iii) Further, as of January 1, 2012, the unadjusted depreciable basis of the 2010 pool of mass assets with a 5-year recovery period is reduced from $25,000 to $22,500 ($25,000 less the unadjusted depreciable basis of $2,500 for the 10 disposed of items), and the depreciation reserve of this 2010 pool is reduced from $13,000 to $11,700 ($13,000 less the depreciation allowed or allowable of $1,300 for the 10 disposed of items as of December 31, 2011). Consequently, as of January 1, 2012, the 2010 pool of mass assets with a 5-year recovery period has 90 items with a total cost of $22,500 and a depreciation reserve of $11,700. Thus, the depreciation allowance for this pool for 2012 is $4,320 ($22,500 × 19.2 percent).

Example 7. (i) Same facts as in *Example 6.* Because of changes in E's recordkeeping in 2013, it is impracticable for E to continue to identify disposed of mass assets using specific identification and to determine the unadjusted depreciable basis of the disposed of mass assets. As a result, E files a Form 3115, Application for Change in Accounting Method, to change to a first-in, first-out method beginning with the taxable year beginning on January 1, 2013, on a modified cut-off basis. *See* § 1.446–1(e)(2)(ii)(*d*)(*2*)(*vii*). Under the first-in, first-out method, the mass assets disposed of in a taxable year are deemed to be from the pool with the earliest placed-in-service year that has assets as of the beginning of the taxable year of the disposition with the same recovery period as the asset disposed of. The Commissioner of Internal Revenue consents to this change in method of accounting.

(ii) During 2013, E sells 20 items of mass assets with a 5-year recovery period each for $50. As of January 1, 2013, the 2006 pool is the pool with the earliest placed-in-service year for mass assets with a 5-year recovery period, and this pool contains 25 items of mass assets with a total cost of $10,000 and a total depreciation reserve of $10,000. Thus, E allocates a cost of $400 ($10,000 × (1/25)) to each disposed of mass asset and depreciation allowed or allowable of $400 to each disposed of mass asset. As a result, the adjusted depreciable basis of each disposed of mass asset is $0. Thus, E recognizes a gain of $50 for each disposed of mass asset in 2013, which is subject to section 1245.

(iii) Further, as of January 1, 2013, the unadjusted depreciable basis of the 2006 pool of mass assets with a 5-year recovery period is reduced from $10,000 to $2,000 ($10,000 less the unadjusted depreciable basis of $8,000 for the 20 disposed of items ($400 × 20)), and the depreciation reserve of this 2006 pool is reduced from $10,000 to $2,000 ($10,000 less the depreciation allowed or allowable of $8,000 for the 20 disposed of items as of December 31, 2012). Consequently, as of January 1, 2013, the 2006 pool of mass assets with a 5-year recovery period has 5 items with a total cost of $2,000 and a depreciation reserve of $2,000.

(i) *Effective/applicability date.* (1) This section applies to taxable years beginning on or after January 1, 2012.

(2) *Change in method of accounting.* A change to comply with this section for depreciable assets placed in service in a taxable year ending on or after December 30, 2003, is a change in method of accounting to which the provisions of section 446(e) and the regulations under section 446(e) apply. A taxpayer also may treat a change to comply with this section for depreciable assets placed in service in a taxable year ending before December 30, 2003, as a change in method of accounting to which the provisions of section 446(e) and the regulations under section 446(e) apply.

(3) *Expiration Date.* The applicability of this section expires on December 23, 2014.

■ **Par. 23.** Section 1.263(a)–0 is amended by:

■ 1. Revising the section headings of the table of contents for §§ 1.263(a)–2 and 1.263(a)–3.

■ 2. Adding entries to the table of contents for §§ 1.263(a)–1, 1.263(a)–2, and 1.263(a)–3.

The revisions and additions read as follows:

§ 1.263(a)–0 Table of contents.

* * * * *

§ 1.263(a)–1 Capital expenditures; in general.

(a) through (h) [Reserved]. For further guidance, see the table of contents for § 1.263(a)–1T(a) through (h) under § 1.263(a)–0T.

§ 1.263(a)–2 Amounts paid to acquire or produce tangible property.

(a) through (i) [Reserved]. For further guidance, see the table of contents for § 1.263(a)–2T(a) through (i) under § 1.263(a)–0T.

§ 1.263(a)–3 Amounts paid to improve tangible property.

(a) through (q) [Reserved]. For further guidance, see the table of contents for § 1.263(a)–3T(a) though (q) under § 1.263(a)–0T.

* * * * *

■ **Par. 24.** Section 1.263(a)–0T is added to read as follows:

§ 1.263(a)–0T Table of contents (temporary).

This section lists the table of contents for §§ 1.263(a)–1T, 1.263(a)–2T, and 1.263(a)–3T.

§ 1.263(a)–1T Capital expenditures; in general (temporary).

§ 1.263(a)–2T Amounts paid to acquire or produce tangible property (temporary).

§ 1.263(a)–3T Amounts paid to improve tangible property (temporary).

(iii) Lessor improvements.
(A) Requirement to capitalize.
(B) Unit of property for lessor improvements.
(iv) Examples.
(2) Compliance with regulatory requirements.
(3) Certain costs incurred during an improvement.
(i) In general.
(ii) Exception for individuals' residences.
(4) Aggregate of related amounts.
(g) Safe harbor for routine maintenance on property other than buildings.
(1) In general.
(2) Rotable and temporary spare parts.
(3) Exceptions.
(4) Class life.
(5) Examples.
(h) Capitalization of betterments.
(1) In general.
(2) Betterments to buildings.
(3) Application of general rule.
(i) Facts and circumstances.
(ii) Unavailability of replacement parts.
(iii) Appropriate comparison.
(A) In general.
(B) Normal wear and tear.
(C) Particular event.
(4) Examples.
(i) Capitalization of restorations.
(1) In general.
(2) Restorations of buildings.
(3) Rebuild to like-new condition.
(4) Replacement of a major component or substantial structural part.
(5) Examples.
(j) Capitalization of amounts to adapt property to a new or different use.
(1) In general.
(2) Adapting buildings to new or different use.
(3) Examples.
(k) Optional regulatory accounting method.
(1) In general.
(2) Eligibility for regulatory accounting method.
(3) Description of regulatory accounting method.
(4) Examples.
(l) Methods of accounting authorized in published guidance.
(m) Treatment of capital expenditures.
(n) Recovery of capitalized amounts.
(o) Accounting method changes.
(p) Effective/applicability date.
(q) Expiration date.

■ **Par. 25.** Section 1.263(a)–1 is revised to read as follows:

§ 1.263(a)–1 Capital expenditures; in general.

(a) through (c) [Reserved]. For further guidance, see § 1.263(a)&1T(a) through (c).

(d) through (h) [Reserved]. For further guidance, see § 1.263(a)–1T(d) through (h).

■ **Par. 26.** Section 1.263(a)–1T is added to read as follows:

§ 1.263(a)–1T Capital expenditures; in general (temporary)—

(a) *General rule for capital expenditures.* Except as provided in chapter 1 of the Internal Revenue Code, no deduction is allowed for—

(1) Any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate; or

(2) Any amount paid in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

(b) *Coordination with section 263A.* Section 263(a) generally requires taxpayers to capitalize an amount paid to acquire, produce, or improve real or personal tangible property. Section 263A generally prescribes the direct and indirect costs that must be capitalized to property produced by the taxpayer and property acquired for resale.

(c) *Examples of capital expenditures.* The following amounts paid are examples of capital expenditures:

(1) An amount paid to acquire or produce a unit of real or personal tangible property. *See* § 1.263(a)–2T.

(2) An amount paid to improve a unit of real or personal tangible property. *See* § 1.263(a)–3T.

(3) An amount paid to acquire or create intangibles. *See* § 1.263(a)–4.

(4) An amount paid or incurred to facilitate an acquisition of a trade or business, a change in capital structure of a business entity, and certain other transactions. *See* § 1.263(a)–5.

(5) An amount paid to acquire or create interests in land, such as easements, life estates, mineral interests, timber rights, zoning variances, or other interests in land.

(6) An amount assessed and paid under an agreement between bondholders or shareholders of a corporation to be used in a reorganization of the corporation or voluntary contributions by shareholders to the capital of the corporation for any corporate purpose. *See* section 118 and § 1.118–1.

(7) An amount paid by a holding company to carry out a guaranty of dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stockholdings in the subsidiary. This amount must be added to the cost of the stock in the subsidiary.

(d) *Amounts paid to sell property*—(1) *In general.* Commissions and other transaction costs paid to facilitate the sale of property generally must be capitalized. However, in the case of dealers in property, amounts paid to facilitate the sale of property are treated as ordinary and necessary business expenses. See § 1.263(a)–5(g) for the treatment of amounts paid to facilitate the disposition of assets that constitute a trade or business.

(2) *Treatment of capitalized amount.* Amounts capitalized under paragraph (d)(1) of this section are treated as a reduction in the amount realized and generally are taken into account either in the taxable year in which the sale occurs or in the taxable year in which the sale is abandoned if a loss deduction is permissible. The capitalized amount is not added to the basis of the property and is not treated as an intangible under § 1.263(a)–4.

(3) *Examples.* The following examples, which assume the sale is not an installment sale under section 453, illustrate the rules of this paragraph (d):

Example 1. Sales costs of real property. X owns a parcel of real estate. X sells the real estate and pays legal fees, recording fees, and sales commissions to facilitate the sale. X must capitalize the fees and commissions and, in the taxable year of the sale, offset the fees and commissions against the amount realized from the sale of the real estate.

Example 2. Sales costs of dealers. Assume the same facts as in *Example 1,* except that X is a dealer in real estate. The commissions and fees paid to facilitate the sale of the real estate are treated as ordinary and necessary business expenses under section 162.

Example 3. Sales costs of personal property used in a trade or business. X owns a truck for use in X's trade or business. X decides to sell the truck on November 15, Year 1. X pays for an appraisal to determine a reasonable asking price. On February 15, Year 2, X sells the truck to Y. X is required to capitalize in Year 1 the amount paid to appraise the truck and, in Year 2, is required to offset the amount paid against the amount realized from the sale of the truck.

Example 4. Costs of abandoned sale of personal property used in a trade or business. Assume the same facts as in *Example 3,* except that, instead of selling the truck on February 15, Year 2, X decides on that date not to sell the truck and takes the truck off the market. X is required to capitalize in Year 1 the amount paid to appraise the truck. However, X may treat the amount paid to appraise the truck as a loss under section 165 in Year 2 when the sale is abandoned.

Example 5. Sales costs of personal property not used in a trade or business. Assume the same facts as in *Example 3,* except that X does not use the truck in X's trade or business, but instead uses it for personal purposes. X decides to sell the truck and on November 15, Year 1, X pays for an appraisal to determine a reasonable asking price. On February 15, Year 2, X sells the truck to *Y.*

X is required to capitalize in Year 1 the amount paid to appraise the truck and, in Year 2, is required to offset the amount paid against the amount realized from the sale of the truck.

Example 6. Costs of abandoned sale of personal property not used in a trade or business. Assume the same facts as in *Example 5,* except that, instead of selling the truck on February 15, Year 2, X decides on that date not to sell the truck and takes the truck off the market. X is required to capitalize in Year 1 the amount paid to appraise the truck. Although the sale is abandoned in Year 2, X may not treat the amount paid to appraise the truck as a loss under section 165 because the truck was not used in X's trade or business or in a transaction entered into for profit.

(e) *Amount paid.* In the case of a taxpayer using an accrual method of accounting, the terms *amount paid* and *payment* mean a liability incurred (within the meaning of § 1.446–1(c)(1)(ii)). A liability may not be taken into account under this section prior to the taxable year during which the liability is incurred.

(f) *Accounting method changes.* Except as otherwise provided in this section, a change to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481, and the regulations thereunder apply. A taxpayer seeking to change to a method of accounting permitted in this section must secure the consent of the Commissioner in accordance with § 1.446–1(e) and follow the administrative procedures issued under § 1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to change its accounting method.

(g) *Effective/applicability date.* This section applies to taxable years beginning on or after January 1, 2012. For the applicability of regulations to taxable years beginning before January 1, 2012, see § 1.263(a)–1 in effect prior to January 1, 2012 (§ 1.263(a)–1 as contained in 26 CFR part 1 edition revised as of April 1, 2011).

(h) *Expiration date.* The applicability of this section expires on December 23, 2014.

■ **Par. 27.** Section 1.263(a)–2 is revised to read as follows:

§ 1.263(a)–2 Amounts paid to acquire or produce tangible property.

(a) through (h) [Reserved]. For further guidance, see §§ 1.263(a)–2T(a) through (h).

(i) through (l) [Reserved]. For further guidance, see §§ 1.263(a)–2T(i) through (l).

■ **Par. 28.** Section 1.263(a)–2T is added to read as follows:

§ 1.263(a)–2T Amounts paid to acquire or produce tangible property (temporary).

(a) *Overview.* This section provides rules for applying section 263(a) to amounts paid to acquire or produce a unit of real or personal property. Paragraph (b) of this section contains definitions. Paragraph (c) of this section contains the rules for coordinating this section with other provisions of the Internal Revenue Code. Paragraph (d) of this section provides the general requirement to capitalize amounts paid to acquire or produce a unit of real or personal property. Paragraph (e) of this section provides the requirement to capitalize amounts paid to defend or perfect title to real or personal property. Paragraph (f) of this section provides the rules for determining the extent to which taxpayers must capitalize transaction costs related to the acquisition of property. Paragraph (g) of this section provides a de minimis rule for certain amounts paid for the acquisition or production of property. Paragraphs (h) and (i) of this section address the treatment and recovery of capital expenditures. Paragraph (j) of this section provides for changes in methods of accounting to comply with this section, and paragraphs (k) and (l) of this section provide the effective, applicability, and expiration dates for the rules under this section.

(b) *Definitions.* For purposes of this section, the following definitions apply:

(1) *Amount paid.* In the case of a taxpayer using an accrual method of accounting, the terms *amount paid* and *payment* mean a liability incurred (within the meaning of § 1.446–1(c)(1)(ii)). A liability may not be taken into account under this section prior to the taxable year during which the liability is incurred.

(2) *Personal property* means tangible personal property as defined in § 1.48–1(c).

(3) *Real property* means land and improvements thereto, such as buildings or other inherently permanent structures (including items that are structural components of the buildings or structures) that are not personal property as defined in paragraph (b)(2) of this section. Any property that constitutes other tangible property under § 1.48–1(d) is treated as real property for purposes of this section. Local law is not controlling in determining whether property is real property for purposes of this section.

(4) *Produce* means construct, build, install, manufacture, develop, create, raise, or grow. This definition is intended to have the same meaning as the definition used for purposes of section 263A(g)(1) and § 1.263A–2(a)(1)(i), except that improvements are excluded from the definition in this paragraph (b)(4) and are separately defined and addressed in § 1.263(a)–3T.

(c) *Coordination with other provisions of the Internal Revenue Code*—(1) *In general.* Except as provided under the de minimis rule in paragraph (g) of this section, nothing in this section changes the treatment of any amount that is specifically provided for under any provision of the Internal Revenue Code or regulations thereunder other than section 162(a) or section 212 and the regulations under those sections. For example, see section 263A requiring taxpayers to capitalize the direct and indirect costs of producing property or acquiring property for resale. See also section 195 requiring taxpayers to capitalize certain costs as start-up expenditures.

(2) *Materials and supplies.* Except as provided under the de minimis rule in paragraph (g) of this section, nothing in this section changes the treatment of amounts paid to acquire or produce property that is properly treated as materials and supplies under § 1.162–3T.

(d) *Acquired or produced tangible property*—(1) *Requirement to capitalize.* Except as provided in paragraph (g) of this section (providing the de minimis rule) and in § 1.162–3T (relating to materials and supplies), a taxpayer must capitalize amounts paid to acquire or produce a unit of real or personal property (as determined under § 1.263(a)–3T(e)), including leasehold improvement property, land and land improvements, buildings, machinery and equipment, and furniture and fixtures. Amounts paid to acquire or produce a unit of real or personal property include the invoice price, transaction costs as determined under paragraph (f) of this section, and costs for work performed prior to the date that the unit of property is placed in service by the taxpayer (without regard to any applicable convention under section 168(d)). A taxpayer also must capitalize amounts paid to acquire real or personal property for resale and to produce real or personal property. See section 263A for the costs required to be capitalized to property produced by the taxpayer or to property acquired for resale.

(2) *Examples.* The rules of this section are illustrated by the following examples, in which it is assumed that the taxpayer does not apply the de minimis rule under paragraph (g) of this section:

Example 1. Acquisition of personal property. X purchases new cash registers for use in its retail store located in leased space in a shopping mall. Assume each cash register is a unit of property as determined under § 1.263(a)–3T(e) and is not a material or supply under § 1.162–3T. X must capitalize under this paragraph (d)(1) the amount paid to acquire each cash register.

Example 2. Acquisition of personal property that is a material or supply; coordination with § 1.162–3T. X operates a fleet of aircraft. In Year 1, X acquires a stock of component parts, which it intends to use to maintain and repair its aircraft. X does not make elections under § 1.162–3T(d) to treat the materials and supplies as capital expenditures. In Year 2, X uses the component parts in the repair and maintenance of its aircraft. Because the parts are materials and supplies under § 1.162–3T, X is not required to capitalize the amounts paid for the parts under this paragraph (d)(1). Rather, X must apply the rules in § 1.162–3T, governing the treatment of materials and supplies, to determine the treatment of these amounts.

Example 3. Acquisition of unit of personal property; coordination with § 1.162–3T. X operates a rental business that rents out a variety of small individual items to customers (rental items). X maintains a supply of rental items on hand to replace worn or damaged items. X purchases a large quantity of rental items to be used in its business. Assume that each of these rental items is a unit of property under § 1.263(a)–3T(e). Also assume that a portion of the rental items are materials and supplies under § 1.162–3T(c)(1). Under paragraph (d)(1) of this section, X must capitalize the amounts paid for the rental items that are not materials and supplies under § 1.162–3T(c)(1). However, X must apply the rules in § 1.162–3T to determine the treatment of the rental items that are materials and supplies under § 1.162–3T(c)(1).

Example 4. Acquisition or production cost. X purchases and produces jigs, dies, molds, and patterns for use in the manufacture of X's products. Assume that each of these items is a unit of property as determined under § 1.263(a)–3T(e) and is not a material and supply under § 1.162–3T(c)(1). X is required to capitalize under paragraph (d)(1) of this section the amounts paid to acquire and produce the jigs, dies, molds, and patterns. See section 263A for the costs required to be capitalized to the property acquired or produced by X.

Example 5. Acquisition of land. X purchases a parcel of undeveloped real estate. X must capitalize under paragraph (d)(1) of this section the amount paid to acquire the real estate. See paragraph (f) of this section for the treatment of amounts paid to facilitate the acquisition of real property.

Example 6. Acquisition of building. X purchases a building. X must capitalize under paragraph (d)(1) of this section the amount paid to acquire the building. See paragraph (f) of this section for the treatment of amounts paid to facilitate the acquisition of real property.

Example 7. Acquisition of property for resale and production of property for sale. X purchases goods for resale and produces other goods for sale. X must capitalize under paragraph (d)(1) of this section the amounts paid to acquire and produce the goods. See section 263A for the costs required to be capitalized to the property produced or property acquired for resale.

Example 8. Production of building. X constructs a building. X must capitalize under paragraph (d)(1) of this section the amount paid to construct the building. See section 263A for the costs required to be capitalized to the real property produced by X.

Example 9. Acquisition of assets constituting a trade or business. Y owns tangible and intangible assets that constitute a trade or business. X purchases all the assets of Y in a taxable transaction. X must capitalize under paragraph (d)(1) of this section the amount paid for the tangible assets of Y. See § 1.263(a)–4 for the treatment of amounts paid to acquire intangibles and § 1.263(a)–5 for the treatment of amounts paid to facilitate the acquisition of assets that constitute a trade or business. See section 1060 for special allocation rules for certain asset acquisitions.

Example 10. Work performed prior to placing the property in service. In Year 1, X purchases a building for use as a business office. Prior to placing the building in service, X incurs costs to repair cement steps, refinish wood floors, patch holes in walls, and paint the interiors and exteriors of the building. In Year 2, X places the building in service and begins using the building as its business office. Assume that the work that X performs does not constitute an improvement to the building or its structural components under § 1.263(a)–3T. Under § 1.263–3T(e)(2)(i), the building and its structural components is a single unit of property. Under paragraph (d)(1) of this section, the amounts paid must be capitalized as costs of acquiring the building because they were for work performed prior to X's placing the building in service.

Example 11. Work performed prior to placing the property in service. In January Year 1, X purchases a new machine for use in an existing production line of its manufacturing business. Assume that the machine is a unit of property under § 1.263(a)–3T(e) and is not a material or supply under § 1.162–3T. After the machine is installed, X performs a critical test on the machine to ensure that it will operate in accordance with quality standards. On November 1, Year 1, the critical test is complete, and X places the machine in service on the production line. X performs periodic quality control testing after the machine is placed in service. Under paragraph (d)(1) of this section, the amounts paid for the installation and the critical test performed before the machine is placed in service must be capitalized as costs of acquiring the machine. However, amounts paid for periodic quality control testing after X placed the machine in service are not required to be capitalized as a cost of acquiring the machine.

(e) *Defense or perfection of title to property*—(1) *In general.* Amounts paid to defend or perfect title to real or personal property are amounts paid to acquire or produce property within the meaning of this section and must be capitalized. See section 263A for the costs required to be capitalized to property produced by the taxpayer or to property acquired for resale.

(2) *Examples.* The following examples illustrate the rule of paragraph (e):

Example 1. Amounts paid to contest condemnation. X owns real property located in County. County files an eminent domain complaint condemning a portion of X's property to use as a roadway. X hires an attorney to contest the condemnation. The amounts that X paid to the attorney must be capitalized because they were to defend X's title to the property.

Example 2. Amounts paid to invalidate ordinance. X is in the business of quarrying and supplying for sale sand and stone in a certain municipality. Several years after X establishes its business, the municipality in which it is located passes an ordinance that prohibits the operation of X's business. X incurs attorney's fees in a successful prosecution of a suit to invalidate the municipal ordinance. X prosecutes the suit to preserve its business activities and not to defend X's title in the property. Therefore, the attorney's fees that X paid are not required to be capitalized under paragraph (e)(1) of this section. See section 263A for the rules requiring direct and allocable indirect costs (including otherwise deductible costs) to be capitalized to property produced or property acquired for resale.

Example 3. Amounts paid to challenge building line. The board of public works of a municipality establishes a building line across X's business property, adversely affecting the value of the property. X incurs legal fees in unsuccessfully litigating the establishment of the building line. The amounts X paid to the attorney must be capitalized because they were to defend X's title to the property.

(f) *Transaction costs*—(1) *In general.* A taxpayer must capitalize amounts paid to facilitate the acquisition or production of real or personal property. See section 263A for the costs required to be capitalized to property produced by the taxpayer or to property acquired for resale. See § 1.263(a)–5 for the treatment of amounts paid to facilitate the acquisition of assets that constitute a trade or business. See § 1.167(a)–5 for allocations of facilitative costs between depreciable and non-depreciable property.

(2) *Scope of facilitate*—(i) *In general.* Except as otherwise provided in this section, an amount is paid to facilitate the acquisition of real or personal property if the amount is paid in the process of investigating or otherwise pursuing the acquisition. Whether an amount is paid in the process of investigating or otherwise pursuing the acquisition is determined based on all of the facts and circumstances. In determining whether an amount is paid to facilitate an acquisition, the fact that the amount would (or would not) have been paid but for the acquisition is

relevant but is not determinative. Amounts paid to facilitate an acquisition include, but are not limited to, inherently facilitative amounts specified in paragraph (f)(2)(ii) of this section.

(ii) *Inherently facilitative amounts.* An amount is paid in the process of investigating or otherwise pursuing the acquisition of real or personal property if the amount is inherently facilitative. An amount is inherently facilitative if the amount is paid for—

(A) Transporting the property (for example, shipping fees and moving costs);

(B) Securing an appraisal or determining the value or price of property;

(C) Negotiating the terms or structure of the acquisition and obtaining tax advice on the acquisition;

(D) Application fees, bidding costs, or similar expenses;

(E) Preparing and reviewing the documents that effectuate the acquisition of the property (for example, preparing the bid, offer, sales contract, or purchase agreement);

(F) Examining and evaluating the title of property;

(G) Obtaining regulatory approval of the acquisition or securing permits related to the acquisition, including application fees;

(H) Conveying property between the parties, including sales and transfer taxes, and title registration costs;

(I) Finders' fees or brokers' commissions, including amounts paid that are contingent on the successful closing of the acquisition;

(J) Architectural, geological, engineering, environmental, or inspection services pertaining to particular properties; or

(K) Services provided by a qualified intermediary or other facilitator of an exchange under section 1031.

(iii) *Special rule for acquisitions of real property*—(A) *In general.* Except as provided in paragraph (f)(2)(ii) of this section (relating to inherently facilitative amounts), an amount paid by the taxpayer in the process of investigating or otherwise pursuing the acquisition of real property does not facilitate the acquisition if it relates to activities performed in the process of determining whether to acquire real property and which real property to acquire.

(B) *Acquisitions of real and personal property in a single transaction.* An amount paid by the taxpayer in the process of investigating or otherwise pursuing the acquisition of personal property facilitates the acquisition of such personal property even if such property is acquired in a single transaction that also includes the acquisition of real property subject to the special rule set out in paragraph (f)(2)(iii)(A) of this section. A taxpayer may use a reasonable allocation to determine which costs facilitate the acquisition of personal property and which costs relate to the acquisition of real property and are subject to the special rule of paragraph (f)(2)(iii)(A) of this section.

(iv) *Employee compensation and overhead costs*—(A) *In general.* For purposes of paragraph (f) of this section, amounts paid for employee compensation (within the meaning of § 1.263(a)–4(e)(4)(ii)) and overhead are treated as amounts that do not facilitate the acquisition of real or personal property. See section 263A, however, for the treatment of employee compensation and overhead costs required to be capitalized to property produced by the taxpayer or to property acquired for resale.

(B) *Election to capitalize.* A taxpayer may elect to treat amounts paid for employee compensation or overhead as amounts that facilitate the acquisition of property. The election is made separately for each acquisition and applies to employee compensation or overhead, or both. For example, a taxpayer may elect to treat overhead, but not employee compensation, as amounts that facilitate the acquisition of property. A taxpayer makes the election by treating the amounts to which the election applies as amounts that facilitate the acquisition in the taxpayer's timely filed original Federal income tax return (including extensions) for the taxable year during which the amounts are paid. In the case of an S corporation or a partnership, the election is made by the S corporation or by the partnership, and not by the shareholders or partners. A taxpayer may revoke an election made under this paragraph (f)(2)(iv)(B) with respect to each acquisition only by filing a request for a private letter ruling and obtaining the Commissioner's consent to revoke the election. The Commissioner may grant a request to revoke this election if the taxpayer can demonstrate good cause for the revocation. An election may not be made or revoked through the filing of an application for change in accounting method or, before obtaining the Commissioner's consent to make the late election or to revoke the election, by filing an amended Federal income tax return.

(3) *Treatment of transaction costs*—(i) *In general.* All amounts paid to facilitate the acquisition or production of real or personal property are capital expenditures. Facilitative amounts allocable to real or personal property must be included in the basis of the property acquired or produced.

(ii) *Treatment of inherently facilitative amounts.* Inherently facilitative amounts allocable to real or personal property are capital expenditures related to such property even if the property is not eventually acquired or produced. Inherently facilitative amounts allocable to real or personal property not acquired may be allocated to those properties and recovered as appropriate in accordance with the applicable provisions of the Internal Revenue Code and the regulations thereunder (for example, sections 165, 167, or 168). See paragraph (i) of this section for the recovery of capitalized amounts.

(4) *Examples.* The following examples illustrate the rules of paragraph (f) of this section:

Example 1. Broker's fees to facilitate an acquisition. X decides to purchase a building in which to relocate its offices and hires a real estate broker to find a suitable building. X pays fees to the broker to find property for X to acquire. Under paragraph (f)(2)(ii)(I) of this section, X must capitalize the amounts paid to the broker because these costs are inherently facilitative of the acquisition of real property.

Example 2. Inspection and survey costs to facilitate an acquisition. X decides to purchase building A and pays amounts to third-party contractors for a termite inspection and an environmental survey of building A. Under paragraph (f)(2)(ii)(J) of this section, X must capitalize the amounts paid for the inspection and the survey of the building because these costs are inherently facilitative of the acquisition of real property.

Example 3. Moving costs to facilitate an acquisition. X purchases all the assets of Y and, in connection with the purchase, hires a transportation company to move storage tanks from Y's plant to X's plant. Under paragraph (f)(2)(ii)(A) of this section, X must capitalize the amount paid to move the storage tanks from Y's plant to X's plant because this cost is inherently facilitative to the acquisition of personal property.

Example 4. Geological and geophysical costs; coordination with other provisions. X is in the business of exploring, purchasing, and developing properties in the United States for the production of oil and gas. X considers acquiring a particular property but first incurs costs for the services of an engineering firm to perform geological and geophysical studies to determine if the property is suitable for oil or gas production. Assume that the amounts that X paid to the engineering firm constitute geological and geophysical expenditures under section 167(h). Although the amounts that X paid for the geological and geophysical services are inherently facilitative to the acquisition of real property under paragraph (f)(2)(ii)(J) of this section, X is not required to include those amounts in the basis of the real property acquired. Rather, under paragraph (c) of this section, X must capitalize these costs separately and amortize such costs as required under section 167(h) (addressing the amortization of geological and geophysical expenditures).

Example 5. Scope of facilitate. X is in the business of providing legal services to clients. X is interested in acquiring a new conference table for its office. X hires and incurs fees for an interior designer to shop for, evaluate, and make recommendations to X regarding which new table to acquire. Under paragraphs (f)(1) and (2) of this section, X must capitalize the amounts paid to the interior designer to provide these services because they are paid in the process of investigating or otherwise pursuing the acquisition of personal property.

Example 6. Transaction costs allocable to multiple properties. X, a retailer, wants to acquire land for the purpose of building a new distribution facility for its products. X considers various properties on highway A in state B. X incurs fees for the services of an architect to advise and evaluate the suitability of the sites for the type of facility that X intends to construct on the selected site. X must capitalize the architect fees as amounts paid to acquire land because these amounts are inherently facilitative to the acquisition of land under paragraph (f)(2)(ii)(J) of this section.

Example 7. Transaction costs allocable to multiple properties. X, a retailer, wants to acquire land for the purpose of building a new distribution facility for its products. X considers various properties on highway A in state B. X incurs fees for the services of an architect to prepare preliminary floor plans for a building that X could construct at any of the sites. Under these facts, the architect's fees are not inherently facilitative to the acquisition of land under paragraph (f)(2)(iii)(J) of this section but are allocable as construction costs of the building under section 263A. Therefore, X does not capitalize the architect fees as amounts paid to acquire land but instead must capitalize these costs as indirect costs allocable to the production of property under section 263A.

Example 8. Special rule for acquisitions of real property. X owns several retail stores. X decides to examine the feasibility of opening a new store in city A. In October, Year 1, X hires and incurs costs for a development consulting firm to study city A and perform market surveys, evaluate zoning and environmental requirements, and make preliminary reports and recommendations as to areas that X should consider for purposes of locating a new store. In December, Year 1, X continues to consider whether to purchase real property in city *A* and which property to acquire. X hires, and incurs fees for, an appraiser to perform appraisals on two different sites to determine a fair offering price for each site. In March, Year 2, X decides to acquire one of these two sites for the location of its new store. At the same time, X determines not to acquire the other site. Under paragraph (f)(2)(iii) of this section, X is not required to capitalize amounts paid to the development consultant in Year 1 because the amounts relate to activities performed in the process of determining whether to acquire real property and which real property to acquire and the amounts are not inherently facilitative costs under paragraph (f)(2)(ii) of this section. However, X must capitalize amounts paid to the appraiser in Year 1 because the appraisal costs are inherently facilitative costs under paragraph (f)(2)(ii)(B) of this section. In Year 2, X must include the appraisal costs allocable to property acquired in the basis of the property acquired and may recover the appraisal costs allocable to the property not acquired in accordance with paragraphs (f)(3)(ii) and (i) of this section.

Example 9. Employee compensation and overhead. X, a freight carrier, maintains an acquisition department whose sole function is to arrange for the purchase of vehicles and aircraft from manufacturers or other parties to be used in its freight carrying business. As provided in paragraph (f)(2)(iv)(A) of this section, X is not required to capitalize any portion of the compensation paid to employees in its acquisition department or any portion of its overhead allocable to its acquisition department. However, under paragraph (f)(2)(iv)(B) of this section, X may elect to capitalize the compensation and overhead costs allocable to the acquisition of a vehicle or aircraft by treating these amounts as costs that facilitate the acquisition of that property in its timely filed original federal income tax return for the year the amounts are paid.

(g) *De minimis rule*—(1) *In general.* Except as otherwise provided in this paragraph (g), a taxpayer is not required to capitalize under paragraph (d)(1) of this section nor treat as a material or supply under § 1.162–3T(a) amounts paid for the acquisition or production (including any amounts paid to facilitate the acquisition or production) of a unit of property (as determined under § 1.263(a)–3T(e)) or for the acquisition or production of any material or supply (as defined in § 1.162–3T(c)(1)) if—

(i) The taxpayer has an applicable financial statement (as defined in paragraph (g)(6) of this section);

(ii) The taxpayer has at the beginning of the taxable year written accounting procedures treating as an expense for non-tax purposes the amounts paid for property costing less than a certain dollar amount;

(iii) The taxpayer treats the amounts paid during the taxable year as an expense on its applicable financial statement in accordance with its written accounting procedures; and

(iv) The total aggregate of amounts paid and not capitalized under paragraph (g)(1) of this section and § 1.162–3T(f) (materials and supplies) for the taxable year are less than or equal to the greater of—

(A) 0.1 percent of the taxpayer's gross receipts for the taxable year as determined for Federal income tax purposes; or

(B) 2 percent of the taxpayer's total depreciation and amortization expense for the taxable year as determined in its applicable financial statement.

(2) *Exceptions to de minimis rule.* The de minimis rule in paragraph (g)(1) of this section does not apply to the following:

(i) Amounts paid for property that is or is intended to be included in inventory property; and

(ii) Amounts paid for land.

(3) *Additional rules.* Property to which a taxpayer applies the de minimis rule contained in paragraph (g) of this section is not treated upon sale or other disposition as a capital asset under section 1221 or as property used in the trade or business under section 1231. The cost of property to which a taxpayer properly applies the de minimis rule contained in paragraph (g) of this section is not required to be capitalized under section 263A to a separate unit of property but may be required to be capitalized as a cost of other property if incurred by reason of the production of the other property. See, for example, § 1.263A–1(e)(3)(ii)(R) requiring taxpayers to capitalize the cost of tools and equipment allocable to property produced or property acquired for resale.

(4) *Election to capitalize.* A taxpayer may elect not to apply the de minimis rule contained in paragraph (g)(1) of this section. An election made under this paragraph (g)(4) may apply to any unit of property during the taxable year to which paragraph (g)(1) of this section would apply (but for the election under this paragraph (g)(4)). A taxpayer makes the election by capitalizing the amounts paid to acquire or produce the unit of property in the taxable year the amounts are paid and by beginning to recover the costs when the unit of property is placed in service by the taxpayer for the purposes of determining depreciation under the applicable provisions of the Internal Revenue Code and the regulations thereunder. A taxpayer must make this election on its timely filed original Federal income tax return (including extensions) for the taxable year the unit of property is placed in service by the taxpayer for the purposes of determining depreciation. In the case of an S corporation or a partnership, the election is made by the S corporation or by the partnership, and not by the shareholders or partners. A taxpayer may revoke an election made under this paragraph (g)(4) with respect to a unit of property only by filing a request for a private letter ruling and obtaining the Commissioner's consent to revoke the election. The Commissioner may grant a request to revoke this election if the

taxpayer can demonstrate good cause for the revocation. An election may not be made or revoked through the filing of an application for change in accounting method or by filing an amended Federal income tax return.

(5) *Materials and supplies.* A taxpayer must treat amounts paid to acquire or produce a unit of property that is a material or supply as defined under § 1.162–3T(c)(1) under § 1.162–3T unless the taxpayer elects under § 1.162–3T(f) to apply the de minimis rule to that property under this paragraph (g). Property to which a taxpayer applies the de minimis rule contained in paragraph (g) of this section is not treated as a material or supply under § 1.162–3T.

(6) *Definition of applicable financial statement.* For purposes of this section (g), the taxpayer's applicable financial statement is the taxpayer's financial statement listed in paragraphs (g)(6)(i) through (iii) of this section that has the highest priority (including within paragraph (g)(6)(ii) of this section). The financial statements are, in descending priority—

(i) A financial statement required to be filed with the Securities and Exchange Commission (SEC) (the 10–K or the Annual Statement to Shareholders);

(ii) A certified audited financial statement that is accompanied by the report of an independent CPA (or in the case of a foreign entity, by the report of a similarly qualified independent professional), that is used for—

(A) Credit purposes;

(B) Reporting to shareholders, partners, or similar persons; or

(C) Any other substantial non-tax purpose; or

(iii) A financial statement (other than a tax return) required to be provided to the federal or a state government or any federal or state agencies (other than the SEC or the Internal Revenue Service).

(7) *Application to consolidated group member.* If the taxpayer is a member of a consolidated group for federal income tax purposes and the member's financial results are reported on the applicable financial statement (as defined in paragraph (g)(6) of this section) for the consolidated group then, for purposes of paragraphs (g)(1)(ii) and (g)(1)(iii) of this section, the written accounting procedures provided for the group and utilized for the group's applicable financial statement may be treated as the written accounting procedures of the member.

(8) *Examples.* The following examples illustrate the rule of this paragraph (g):

Example 1. De minimis rule. X purchases 10 printers at $200 each for a total cost of $2,000. Assume that each printer is a unit of property under § 1.263(a)–3T(e) and is not a material or supply under § 1.162–3T. X has an applicable financial statement and a written policy at the beginning of the taxable year to expense amounts paid for property costing less than $500. X treats the amounts paid for the printers as an expense on its applicable financial statement. Assume that the total aggregate amounts treated as de minimis and not capitalized by X under paragraphs (g)(1)(i), (ii), and (iii) of this section, including the amounts paid for the printers, are less than or equal to the greater of 0.1 percent of total gross receipts or 2 percent of X's total financial statement depreciation under paragraph (g)(1)(iv) of this section. X is not required to capitalize the amounts paid for the 10 printers under paragraph (g)(1) of this section.

Example 2. De minimis rule not met. X is a member of a consolidated group for federal income tax purposes. X's financial results are reported on the consolidated applicable financial statements for the affiliated group. X's affiliated group has a written policy at the beginning of Year 1, which is followed by X, to expense amounts paid for property costing less than $500. In Year 1, X pays $160,000 to purchase 400 computers at $400 each. Assume that each computer is a unit of property under § 1.263(a)–3T(e), is not a material or supply under § 1.162–3T, and that X intends to treat the cost of only the computers as de minimis under paragraph (g)(1) of this section. X treats the amounts paid for the computers as an expense on the applicable financial statements for the affiliated group. For its Year 1 taxable year, X has gross receipts of $125,000,000 for Federal tax purposes and reports $7,000,000 of it's own depreciation and amortization expense on the affiliated group's applicable financial statement. Thus, in order to meet the criteria of paragraph (g)(1)(iv) of this section for Year 1, the total aggregate amounts paid and not capitalized by X under paragraphs (g)(1)(i), (ii), and (iii) of this section must be less than or equal to the greater of $125,000 (0.1 percent of X's total gross receipts of $125,000,000) or $140,000 (2 percent of X's total deprecation and amortization of $7,000,000). Because X pays $160,000 for the computers and this amount exceeds $140,000, the greater of the two limitations provided in paragraph (g)(1)(iv) of this section, X may not apply the de minimis rule under paragraph (g)(1) of this section to the total amounts paid for the 400 computers.

Example 3. De minimis rule; election to capitalize. Assume the same facts as in *Example 2,* except that X makes an election under paragraph (g)(4) of this section to capitalize $20,000, the amounts paid to acquire 50 of the 400 computers purchased in Year 1. Under these facts, the $140,000 paid by X in Year 1 for the remaining 350 computers qualifies for the de minimis rule under paragraph (g)(1) of this section because this amount is equal to 2 percent of X's total depreciation ($140,000), the greater of the two amounts calculated under paragraph (g)(1)(iv) of this section. Accordingly, X is not required to capitalize the amounts paid to acquire the 350 computers in Year 1.

Example 4. Election to apply de minimis rule to certain materials and supplies. (i) X is a corporation that provides consulting services to its customers. X has an applicable financial statement and a written policy at the beginning of the taxable year to expense amounts paid for property costing $500 or less. In Year 1, X purchases 200 computers at $500 each for a total cost of $100,000. Assume that each computer is a unit of property under § 1.263(a)–3T(e) and is not a material or supply under § 1.162–3T. In addition, X purchases 200 office chairs at $100 each for a total cost of $20,000 and 250 customized briefcases at $80 each for a total cost of $20,000. Assume that each office chair and each briefcase is a material or supply under § 1.162–3T(c)(1). In Year 1, X also acquires 10 books at $100 each, which are also materials and supplies under § 1.162–3T(c)(1). X makes the election under § 1.162–3T(f) to apply the de minimis rule to the office chairs and briefcases, but does not make that election for the books and treats the books as materials and supplies in accordance with the provisions of § 1.162–3T. X treats the amounts paid for the computers, office chairs, and briefcases as expenses on its applicable financial statement. Assume also that for Year 1, the amounts that X paid for the computers, office chairs, and briefcases are the only amounts that X intends to treat as de minimis costs not capitalized under paragraph (g)(1) of this section. For its Year 1 taxable year, X has gross receipts of $125,000,000 and reports $7,000,000 of depreciation and amortization on its applicable financial statement.

(ii) In order to meet the requirements of paragraph (g)(1)(iv) of this section for Year 1, X's total aggregate amounts paid and not capitalized under paragraphs (g)(1)(i), (ii), and (iii) of this section must be less than or equal to the greater of $125,000 (0.1 percent of X's total gross receipts of $125,000,000) or $140,000 (2 percent of X's total depreciation and amortization of $7,000,000). X pays a total of $140,000 ($100,000 + $20,000 + $20,000) for the computers, office chairs, and briefcases. X is not required to include the amounts paid for the books in this computation because X has not elected under § 1.162–3T(f) to apply the de minimis rule to the books. Thus, the total aggregate amounts paid and not capitalized under paragraph (g)(1) of this section is equal to $140,000 (2 percent of X's total financial depreciation), the greater of the two limitations set out under paragraph (g)(1)(iv) of this section. Accordingly, under paragraph (g)(1) of this section, in Year 1, X may treat as de minimis and is not required to capitalize the $140,000 paid to acquire the computers, office chairs, and briefcases.

(h) *Treatment of capital expenditures.* Amounts required to be capitalized under this section are capital expenditures and must be taken into account through a charge to capital account or basis, or in the case of property that is inventory in the hands of a taxpayer, through inclusion in inventory costs. See section 263A for the treatment of direct and certain indirect costs of producing property or acquiring property for resale.

(i) *Recovery of capitalized amounts*—(1) *In general.* Amounts that are capitalized under this section are recovered through depreciation, cost of goods sold, or by an adjustment to basis at the time the property is placed in service, sold, used, or otherwise disposed of by the taxpayer. Cost recovery is determined by the applicable provisions of the Internal Revenue Code and regulations relating to the use, sale, or disposition of property.

(2) *Examples.* The following examples illustrate the rule of paragraph (i)(1) of this section. Assume that X does not apply the de minimis rule under paragraph (g) of this section.

Example 1. Recovery when property placed in service. X owns a 10-unit apartment building. The refrigerator in one of the apartments stops functioning, and X purchases a new refrigerator to replace the old one. X pays for the acquisition, delivery, and installation of the new refrigerator. Assume that the refrigerator is the unit of property, as determined under § 1.263(a)–3T(e), and is not a material or supply under § 1.162–3T. Under paragraph (d)(1) of this section, X is required to capitalize the amounts paid for the acquisition, delivery, and installation of the refrigerator. Under paragraph (i) of this section, the capitalized amounts are recovered through depreciation, which begins when the refrigerator is placed in service by X.

Example 2. Recovery when property used in the production of property. X operates a plant where it manufactures widgets. X purchases a tractor loader to move raw materials into and around the plant for use in the manufacturing process. Assume that the tractor loader is a unit of property, as determined under § 1.263(a)–3T(e), and is not a material or supply under § 1.162–3T. Under paragraph (d)(1) of this section, X is required to capitalize the amounts paid to acquire the tractor loader. Under paragraph (i) of this section, the capitalized amounts are recovered through depreciation, which begins when X places the tractor loader in service. However, because the tractor/loader is used in the production of property, under section 263A the cost recovery (that is, the depreciation) on the capitalized amounts must be capitalized to X's property produced, and, consequently, recovered through cost of goods sold. *See* § 1.263A–1(e)(3)(ii)(I).

(j) *Accounting method changes.* Except as otherwise provided in this section, a change to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481, and the regulations thereunder apply. A taxpayer seeking to change to a method of accounting permitted in this section must secure the consent of the Commissioner in accordance with § 1.446–1(e) and follow the administrative procedures issued under § 1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to change its accounting method.

(k) *Effective/applicability date.* Except for paragraphs (f)(2)(iii), (f)(2)(iv),(f)(3)(ii) and (g) of this section, this section generally applies to taxable years beginning on or after January 1, 2012. Paragraphs (f)(2)(iii), (f)(2)(iv), (f)(3)(ii), and (g) of this section apply to amounts paid or incurred (to acquire or produce property) in taxable years beginning on or after January 1, 2012. For the applicability of regulations to taxable years beginning before January 1, 2012, see § 1.263(a)– in effect prior to January 1, 2012 (§ 1.263(a)–2 as contained in 26 CFR part 1 edition revised as of April 1, 2011).

(l) *Expiration Date.* The applicability of this section expires on December 23, 2014.

■ **Par. 29.** Section 1.263(a)–3 is revised to read as follows:

§ 1.263(a)–3 Amounts paid to improve tangible property.

(a) and (b) [Reserved]. For further guidance, see § 1.263(a)–3T(a) and (b).

(c) through (q) [Reserved]. For further guidance, see §§ 1.263(a)–3T(c) through (q).

■ **Par. 30.** Section 1.263(a)–3T is added to read as follows:

§ 1.263(a)–3T Amounts paid to improve tangible property (temporary).

(a) *Overview.* This section provides rules for applying section 263(a) to amounts paid to improve tangible property. Paragraph (b) of this section provides definitions. Paragraph (c) of this section provides rules for coordinating this section with other provisions of the Internal Revenue Code. Paragraph (d) of this section provides the requirement to capitalize amounts paid to improve tangible property and provides the general rules for determining whether a unit of property is improved. Paragraph (e) of this section provides the rules for determining the appropriate unit of property. Paragraph (f) of this section provides special rules for determining improvement costs in particular contexts. Paragraph (g) provides a safe harbor for routine maintenance costs. Paragraph (h) of this section provides rules for determining whether amounts paid result in betterments to the unit of property. Paragraph (i) of this section provides rules for determining whether amounts paid restore the unit of property. Paragraph (j) of this section provides rules for amounts paid to adapt the unit of property to a new or different use. Paragraph (k) of this section provides an optional regulatory accounting method. Paragraph (l) of this section provides for a repair allowance or other methods of accounting identified in published guidance. Paragraphs (m) through (o) of this section provide additional rules related to these provisions. Paragraphs (p) and (q) of this section provides the effective/applicability and expiration dates for the rules in this section.

(b) *Definitions.* For purposes this section, the following definitions apply:

(1) *Amount paid.* In the case of a taxpayer using an accrual method of accounting, the terms *amounts paid* and *payment* mean a liability incurred (within the meaning of § 1.446–1(c)(1)(ii)). A liability may not be taken into account under this section prior to the taxable year during which the liability is incurred.

(2) *Personal property* means tangible personal property as defined in § 1.48–1(c).

(3) *Real property* means land and improvements thereto, such as buildings or other inherently permanent structures (including items that are structural components of the buildings or structures) that are not personal property as defined in paragraph (b)(2) of this section. Any property that constitutes other tangible property under § 1.48–1(d) is also treated as real property for purposes of this section. Local law is not controlling in determining whether property is real property for purposes of this section.

(4) *Owner* means the taxpayer that has the benefits and burdens of ownership of the unit of property for Federal income tax purposes.

(c) *Coordination with other provisions of the Internal Revenue Code*—(1) *In general.* Nothing in this section changes the treatment of any amount that is specifically provided for under any provision of the Internal Revenue Code or the regulations other than section 162(a) or section 212 and the regulations under those sections. For example, see section 263A requiring taxpayers to capitalize the direct and indirect costs of producing property or acquiring property for resale.

(2) *Materials and supplies.* A material or supply as defined in § 1.162–3T(c)(1) that is acquired and used to improve a unit of tangible property is subject to this section and is not treated as a material or supply under § 1.162–3T.

(3) *Exception for amounts subject to de minimis rule.* A taxpayer is not required to capitalize amounts paid to acquire or produce units of property used in improvements under paragraph (d) of this section (including materials and supplies used in improvements) if these amounts are properly deducted

under the de minimis rule of section § 1.263(a)–2(g).

(3) *Example.* The following example illustrates the rules of this paragraph (c):

Example. Railroad rolling stock. X is a railroad that properly treats amounts paid for the rehabilitation of railroad rolling stock as deductible expenses under section 263(d). X is not required to capitalize the amounts paid because nothing in this section changes the treatment of amounts specifically provided for under section 263(d).

(d) *Requirement to capitalize amounts paid for improvements.* Except as provided in the optional regulatory accounting method in paragraph (k) of this section or under any other accounting method published in accordance with paragraph (l) of this section, a taxpayer generally must capitalize the aggregate of related amounts (as defined in paragraph (f)(4) of this section) paid to improve a unit of property owned by the taxpayer. However, see paragraph (f)(1) of this section for the treatment of amounts paid to improve leased property. See section 263A for the costs required to be capitalized to property produced by the taxpayer or to property acquired for resale; section 1016 for adding capitalized amounts to the basis of the unit of property; and section 168 for the treatment of additions or improvements for depreciation purposes. For purposes of this section, a unit of property is improved if the amounts paid for activities performed after the property is placed in service by the taxpayer—

(1) Result in a betterment to the unit of property (see paragraph (h) of this section);

(2) Restore the unit of property (see paragraph (i) of this section); or

(3) Adapt the unit of property to a new or different use (see paragraph (j) of this section).

(e) *Determining the unit of property*—(1) *In general.* The unit of property rules in this paragraph (e) apply only for purposes of section 263(a) and §§ 1.263(a)–1T, 1.263(a)–2T, 1.263(a)–3T, and 1.162–3T. Unless otherwise specified, the unit of property determination is based upon the functional interdependence standard provided in paragraph (e)(3)(i) of this section. However, special rules are provided for buildings (see paragraph (e)(2) of this section), plant property (see paragraph (e)(3)(ii) of this section), network assets (see paragraph (e)(3)(iii) of this section), leased property (see paragraph (e)(2)(v) of this section for leased buildings and paragraph (e)(3)(iv) of this section for leased property other than buildings), and improvements to property (see paragraph (e)(4) of this section). Additional rules are provided if a taxpayer has assigned different MACRS classes or depreciation methods to components of property or subsequently changes the class or depreciation method of a component or other item of property (see paragraph (e)(5) of this section). Property that is aggregated or subject to a general asset account election or accounted for in a multiple asset account (that is, pooled) may not be treated as a single unit of property.

(2) *Building*—(i) *In general.* Except as otherwise provided in paragraphs (e)(4), (e)(5)(ii), and (f)(1)(ii)(B) of this section, in the case of a building (as defined in § 1.48–1(e)(1)), each building and its structural components (as defined in § 1.48–1(e)(2)) is a single unit of property (''building'').

(ii) *Application of improvement rules to a building.* An amount is paid for an improvement to a building under paragraphs (d) and (f)(1)(iii) of this section if the amount paid results in an improvement under paragraph (h), (i), or (j) of this section to any of the following:

(A) *Building structure.* A building structure consists of the building (as defined in § 1.48–1(e)(1)), and its structural components (as defined in § 1.48–1(e)(2)), other than the structural components designated as buildings systems in paragraph (e)(2)(ii)(B) of this section.

(B) *Building system.* Each of the following structural components (as defined in § 1.48–1(e)(2)), including the components thereof, constitutes a building system that is separate from the building structure, and to which the improvement rules must be applied—

(*1*) Heating, ventilation, and air conditioning (''HVAC'') systems (including motors, compressors, boilers, furnace, chillers, pipes, ducts, radiators);

(*2*) Plumbing systems (including pipes, drains, valves, sinks, bathtubs, toilets, water and sanitary sewer collection equipment, and site utility equipment used to distribute water and waste to and from the property line and between buildings and other permanent structures);

(*3*) Electrical systems (including wiring, outlets, junction boxes, lighting fixtures and associated connectors, and site utility equipment used to distribute electricity from property line to and between buildings and other permanent structures);

(*4*) All escalators;

(*5*) All elevators;

(*6*) Fire-protection and alarm systems (including sensing devices, computer controls, sprinkler heads, sprinkler mains, associated piping or plumbing, pumps, visual and audible alarms, alarm control panels, heat and smoke detection devices, fire escapes, fire doors, emergency exit lighting and signage, and fire fighting equipment, such as extinguishers, hoses);

(*7*) Security systems for the protection of the building and its occupants (including window and door locks, security cameras, recorders, monitors, motion detectors, security lighting, alarm systems, entry and access systems, related junction boxes, associated wiring and conduit);

(*8*) Gas distribution system (including associated pipes and equipment used to distribute gas to and from property line and between buildings or permanent structures); and

(*9*) Other structural components identified in published guidance in the **Federal Register** or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter) that are excepted from the building structure under paragraph (e)(2)(ii)(A) of this section and are specifically designated as building systems under this section.

(iii) *Condominium*—(A) *In general.* In the case of a taxpayer that is the owner of an individual unit in a building with multiple units (such as a condominium), the unit of property is the individual unit owned by the taxpayer and the structural components (as defined in § 1.48–1(e)(2)) that are part of the unit (condominium).

(B) *Application of improvement rules to a condominium.* An amount is paid for an improvement to a condominium under paragraph (d) of this section if the amount paid results in an improvement under paragraph (h), (i), or (j) of this section to the building structure (as defined in paragraph (e)(2)(ii)(A) of this section) that is part of the condominium or to the portion of any building system (as defined in paragraph (e)(2)(ii)(B) of this section) that is part of the condominium. In the case of the condominium management association, the association must apply the improvement rules to the building structure or to any building system as determined under paragraphs (e)(2)(ii)(A) and (e)(2)(ii)(B) of this section.

(iv) *Cooperative*—(A) *In general.* In the case of a taxpayer that has an ownership interest in a cooperative housing corporation, the unit of property is the portion of the building in which the taxpayer has possessory rights and the structural components (as defined in § 1.48–1(e)(2)) that are part of the portion of the building subject to the taxpayer's possessory rights (cooperative).

(B) *Application of improvement rules to a cooperative.* An amount is paid for an improvement to a cooperative under paragraph (d) of this section if the amount paid results in an improvement under paragraph (h), (i), or (j) of this section to the portion of the building structure (as defined in paragraph (e)(2)(ii)(A) of this section) in which the taxpayer has possessory rights or to the portion of any building system (as defined in paragraph (e)(2)(ii)(B) of this section) that is part of the portion of the building structure subject to the taxpayer's possessory rights. In the case of a cooperative housing corporation, the corporation must apply the improvement rules to the building structure or to any building system as determined under paragraphs (e)(2)(ii)(A) and (e)(2)(ii)(B) of this section.

(v) *Leased building*—(A) *In general.* In the case of a taxpayer that is a lessee of all or a portion of a building (such as an office, floor, or certain square footage), the unit of property is each building and its structural components or the portion of each building subject to the lease and the structural components associated with the leased portion.

(B) *Application of improvement rules to a leased building.* An amount is paid for an improvement to a leased building or a leased portion of a building under paragraphs (d) and (f)(1)(ii) of this section if the amount paid results in an improvement under paragraph (h), (i), or (j) of this section to any of the following:

(*1*) *Entire building.* In the case of a taxpayer that is a lessee of an entire building, the building structure (as defined under paragraph (e)(2)(ii)(A) of this section) or any building system (as defined under paragraph (e)(2)(ii)(B) of this section) to which the expenditure relates.

(*2*) *Portion of a building.* In the case of a taxpayer that is a lessee of a portion of a building (such as an office, floor, or certain square footage), the portion of the building structure (as defined under paragraph (e)(2)(ii)(A) of this section) subject to the lease or the portion of any building system (as defined under paragraph (e)(2)(ii)(B) of this section) associated with that portion of the leased building structure.

(3) *Property other than building*—(i) *In general.* Except as otherwise provided in paragraphs (e)(3), (e)(4), (e)(5), and (f)(1) of this section, in the case of real or personal property other than property described in paragraph (e)(2) of this section, all the components that are functionally interdependent comprise a single unit of property. Components of property are functionally interdependent if the placing in service of one component by the taxpayer is dependent on the placing in service of the other component by the taxpayer.

(ii) *Plant property*—(A) *Definition.* For purposes of this paragraph (e) of this section, the term *plant property* means functionally interdependent machinery or equipment, other than network assets, used to perform an industrial process, such as manufacturing, generation, warehousing, distribution, automated materials handling in service industries, or other similar activities.

(B) *Unit of property for plant property.* In the case of plant property, the unit of property determined under the general rule of paragraph (e)(3)(i) of this section is further divided into smaller units comprised of each component (or group of components) that performs a discrete and major function or operation within the functionally interdependent machinery or equipment.

(iii) *Network assets*—(A) *Definition.* For purposes of this paragraph (e), the term *network assets* means railroad track, oil and gas pipelines, water and sewage pipelines, power transmission and distribution lines, and telephone and cable lines that are owned or leased by taxpayers in each of those respective industries. The term includes, for example, trunk and feeder lines, pole lines, and buried conduit. It does not include property that would be included as building structure or building systems under paragraphs (e)(2)(ii)(A) and (e)(2)(ii)(B) of this section, nor does it include separate property that is adjacent to, but not part of a network asset, such as bridges, culverts, or tunnels.

(B) *Unit of property for network assets.* In the case of network assets, the unit of property is determined by the taxpayer's particular facts and circumstances except as otherwise provided in published guidance in the **Federal Register** or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter). For these purposes, the functional interdependence standard provided in paragraph (e)(3)(i) of this section is not determinative.

(iv) *Leased property other than buildings.* In the case of a taxpayer that is a lessee of real or personal property other than property described in paragraph (e)(2) of this section, the unit of property for the leased property is determined under paragraphs (e)(3)(i), (ii), (iii), and (e)(5) of this section except that, after applying the applicable rules under those paragraphs, the unit of property may not be larger than the unit of leased property.

(4) *Improvements to property.* An improvement to a unit of property, other than a lessee improvement as determined under paragraph (f)(1)(ii) of this section, is not a unit of property separate from the unit of property improved. For the unit of property for lessee improvements, see paragraph (f)(1)(ii)(B) of this section.

(5) *Additional rules*—(i) *Year placed in service.* Notwithstanding the unit of property determination under paragraph (e)(3) of this section, a component (or a group of components) of a unit property must be treated as a separate unit of property if, at the time the unit of property is initially placed in service by the taxpayer, the taxpayer has properly treated the component as being within a different class of property under section 168(e) (MACRS classes) than the class of the unit of property of which the component is a part, or the taxpayer has properly depreciated the component using a different depreciation method than the depreciation method of the unit of property of which the component is a part.

(ii) *Change in subsequent taxable year.* Notwithstanding the unit of property determination under paragraphs (e)(2), (3), (4), or (5)(i) of this section, in any taxable year after the unit of property is initially placed in service by the taxpayer, if the taxpayer or the Internal Revenue Service changes the treatment of that property (or any portion thereof) to a proper MACRS class or a proper depreciation method (for example, as a result of a cost segregation study or a change in the use of the property), then the taxpayer must change the unit of property determination for that property (or the portion thereof) under this section to be consistent with the change in treatment for depreciation purposes. Thus, for example, if a portion of a unit of property is properly reclassified to a MACRS class different from the MACRS class of the unit of property of which it was previously treated as a part, then the reclassified portion of the property should be treated as a separate unit of property for purposes of this section.

(6) *Examples.* The rules of this paragraph (e) are illustrated by the following examples, in which it is assumed that the taxpayer has not made a general asset account election with regard to property or accounted for property in a multiple asset account. In addition, unless the facts specifically indicate otherwise, assume that the additional rules in paragraph (e)(5) of this section do not apply:

Example 1. Building systems. X owns an office building that contains a HVAC system. The HVAC system incorporates ten roof-mounted units that service different parts of the building. The roof-mounted units are not connected and have separate controls and duct work that distribute the heated or cooled air to different spaces in the building's interior. X pays an amount for labor and materials for work performed on the roof-mounted units. Under paragraph (e)(2)(i) of this section, X must treat the building and its structural components as a single unit of property. As provided under paragraph (e)(2)(ii) of this section, an amount is paid for an improvement to a building if it results in an improvement to the building structure or any designated building system. Under paragraph (e)(2)(ii)(B)(*1*) of this section, the entire HVAC system, including all of the roof-mounted units and their components, comprise a building system. Therefore, under paragraph (e)(2)(ii) of this section, if an amount paid by X for work on the roof-mounted units results in an improvement (for example, a betterment) to the HVAC system, X must treat this amount as an improvement to the building.

Example 2. Building systems. X owns a building that it uses in its retail business. The building contains two elevator banks in different locations in its building. Each elevator bank contains three elevators. X pays an amount for labor and materials for work performed on the elevators. Under paragraph (e)(2)(i) of this section, X must treat the building and its structural components as a single unit of property. As provided under paragraph (e)(2)(ii) of this section, an amount is paid for an improvement to a building if it results in an improvement to the building structure or any designated building system. Under paragraph (e)(2)(ii)(B)(*5*) of this section, all of the elevators, including all their components, comprise a building system. Therefore, under paragraph (e)(2)(ii) of this section, if an amount paid by X for work on the elevators results in an improvement (for example, a betterment) to the entire elevator system, X must treat these amounts as an improvement to the building.

Example 3. Building structure and systems; condominium. X owns a condominium unit in a condominium office building. X uses the condominium unit in its business of providing medical services. The condominium unit contains two restrooms, each of which contains a sink, a toilet, water and drainage pipes and bathroom fixtures. X pays an amount for labor and materials to perform work on the pipes, sinks, toilets, and plumbing fixtures that are part of the condominium unit. Under paragraph (e)(2)(iii) of this section, X must treat the individual unit that it owns, including the structural components that are part of that unit, as a single unit of property. As provided under paragraph (e)(2)(iii)(B) of this section, an amount is paid for an improvement to the condominium if it results in an improvement to the building structure that is part of the unit or to a portion of any designated building system that is part of the unit. Under paragraph (e)(2)(ii)(B)(*2*) of this section, the pipes, sinks, toilets, and plumbing fixtures that are part of X's unit comprise the plumbing system for the condominium unit. Therefore, under paragraph (e)(2)(iii) of this section, if an amount paid by X for work on pipes, sinks, toilets, and plumbing fixtures results in an improvement (for example, a betterment) to the portion of the plumbing system that is part of X's condominium unit, X must treat this amount as an improvement to the condominium.

Example 4. Building structure and systems; property other than buildings. X, a manufacturer, owns a building adjacent to its manufacturing facility that contains office space and related facilities for X's employees that manage and administer X's manufacturing operations. The office building contains equipment, such as desks, chairs, computers, telephones, and bookshelves that are not building structure or building systems. X pays an amount to add an extension to the office building. Under paragraph (e)(2)(i) of this section, X must treat the building and its structural components as a single unit of property. As provided under paragraph (e)(2)(ii) of this section, an amount is paid for an improvement to a building if it results in an improvement to the building structure or any designated building system. Therefore, under paragraph (e)(2)(ii) of this section, if an amount paid by X for the addition of an extension to the office building results in an improvement (for example, a betterment) to the building structure, X must treat this amount as an improvement to the building. In addition, because the equipment contained within the office building constitutes property other than the building, the units of property for the office equipment are initially determined under the general rule in paragraph (e)(3)(i) of this section and are comprised of the groups of components that are functionally interdependent.

Example 5. Plant property; discrete and major function. X is an electric utility company that operates a power plant to generate electricity. The power plant includes a structure that is not a building under § 1.48–1(e)(1), four pulverizers that grind coal, one boiler that produces steam, one turbine that converts the steam into mechanical energy, and one generator that converts mechanical energy into electrical energy. In addition, the turbine contains a series of blades that cause the turbine to rotate when affected by the steam. Because the plant is composed of real and personal tangible property other than a building, the unit of property for the generating equipment is initially determined under the general rule in paragraph (e)(3)(i) of this section and is comprised of all the components that are functionally interdependent. Under this rule, the initial unit of property is the entire plant because the components of the plant are functionally interdependent. However, because the power plant is plant property under paragraph (e)(3)(ii) of this section, the initial unit of property is further divided into smaller units of property by determining the components (or groups of components) that perform discrete and major functions within the plant. Under this paragraph, X must treat the structure, the boiler, the turbine, and the generator each as a separate unit of property, and each of the four pulverizers as a separate unit of property because each of these components performs a discrete and major function within the power plant. X is not required to treat components, such as the turbine blades, as separate units of property because each of these components does not perform a discrete and major function within the plant.

Example 6. Plant property; discrete and major function. X is engaged in a uniform and linen rental business. X owns and operates a plant that utilizes many different machines and equipment in an assembly line-like process to treat, launder, and prepare rental items for its customers. X utilizes two laundering lines in its plant, each of which can operate independently. One line is used for uniforms and another line is used for linens. Both lines incorporate several sorters, boilers, washers, dryers, ironers, folders, and waste water treatment systems. Because the laundering equipment contained within the plant is property other than a building, the unit of property for the laundering equipment is initially determined under the general rule in paragraph (e)(3)(i) of this section and is comprised of all the components that are functionally interdependent. Under this rule, the initial units of property are each laundering line because each line is functionally independent and is comprised of components that are functionally interdependent. However, because each line is comprised of plant property under paragraph (e)(3)(ii) of this section, X must further divide these initial units of property into smaller units of property by determining the components (or groups of components) that perform discrete and major functions within the line. Under paragraph (e)(3)(ii) of this section, X must treat each sorter, boiler, washer, dryer, ironer, folder, and waste water treatment system in each line as a separate unit of property because each of these components performs a discrete and major function within the line.

Example 7. Plant property; industrial process. X operates a restaurant that prepares and serves food to retail customers. Within its restaurant, X has a large piece of equipment that uses an assembly line-like process to prepare and cook tortillas that X serves to its customers. Because the tortilla-making equipment is property other than a building, the unit of property for the equipment is initially determined under the general rule in paragraph (e)(3)(i) of this section and is comprised of all the components that are functionally interdependent. Under this rule, the initial unit of property is the entire tortilla-making equipment because the various components of the equipment are functionally interdependent. The equipment is not plant property under paragraph (e)(3)(ii) of this section because the equipment is not used in an industrial process, as it performs a small-scale function in X's retail restaurant operations. Thus, X is not required to further divide the equipment into separate units of property based on the components that perform discrete and major functions.

Example 8. Personal property. X owns locomotives that it uses in its railroad business. Each locomotive consists of various components, such as an engine, generators, batteries and trucks. X acquired a locomotive with all its components and treated all the components of the locomotive as being within the same class of property under section 168(e) and depreciated all the components using the same depreciation method. Because X's locomotive is property other than a building, the initial unit of property is determined under the general rule in paragraph (e)(3)(i) of this section and is comprised of the components that are functionally interdependent. Under paragraph (e)(3)(i) of this section, the locomotive is a single unit of property because it consists entirely of components that are functionally interdependent.

Example 9. Personal property. X provides legal services to its clients. X purchased a laptop computer and a printer for its employees to use in providing legal services. When X placed the computer and printer into service, X treated the computer and printer and all their components as being within the same class of property under section 168(e) and depreciated all the components using the same depreciation method. Because the computer and printer are property other than a building, the initial units of property are determined under the general rule in paragraph (e)(3)(i) of this section and are comprised of the components that are functionally interdependent. Under paragraph (e)(3)(i) of this section, the computer and the printer are separate units of property because the computer and the printer are not components that are functionally interdependent (that is, the placing in service of the computer is not dependent on the placing in service of the printer).

Example 10. Building structure and systems; leased building. X is a retailer of consumer products. X conducts its retail sales in a building that it leases from Y. The leased building consists of the building structure (including the floor, walls, and a roof) and various building systems, including a plumbing system, an electrical system, a HVAC system, a security system, and a fire protection and prevention system. X pays an amount for labor and materials to perform work on the HVAC system of the leased building. Under paragraph (e)(2)(v)(A) of this section, because X leases the entire building, X must treat the leased building and its structural components as a single unit of property. As provided under paragraph (e)(2)(v)(B) of this section, an amount is paid for an improvement to a leased building if it results in an improvement (for example, a betterment) to the leased building structure or to any building system within the leased building. Therefore, under paragraphs (e)(2)(v)(B)(*1*) and (e)(2)(ii)(B)(*1*) of this section, if an amount paid by X for work on the HVAC system results in an improvement to the heating and air conditioning system in the leased building, X must treat this amount as an improvement to the entire leased building.

Example 11. Production of real property related to leased property. Assume the same facts as in *Example 10,* except that X receives a construction allowance from Y and X uses the construction allowance to build a driveway adjacent to the leased building. Assume that under the terms of the lease, X, the lessee, is treated as the owner of any property that it constructs on or nearby the leased building. Also assume that section 110 does not apply to the construction allowance. Finally, assume that the driveway is not plant property or a network asset. Because the construction of the driveway consists of the production of real property other than a building, all the components of the driveway that are functionally interdependent are a single unit of property under paragraphs (e)(3)(i) and (e)(3)(iv) of this section.

Example 12. Leasehold improvements; construction allowance used for lessor-owned improvements. Assume the same facts as *Example 11,* except that under the terms of the lease Y, the lessor, is treated as the owner of any property constructed on the leased premises. Because Y, the lessor, is the owner of the driveway and the driveway is real property other than a building, all the components of the driveway that are functionally interdependent are a single unit of property under paragraph (e)(3)(i) of this section.

Example 13. Buildings and structural components; leased office space. X provides consulting services to its clients. X conducts its consulting services business in two office spaces in the same building, each of which it leases from Y under separate lease agreements. Each office space contains a separate HVAC unit, which is part of the leased property. Both lease agreements provide that X is responsible for maintaining, repairing, and replacing the HVAC conditioning system that is part of the leased property. X pays amounts to perform work on the HVAC units in each office space. Because X leases two separate office spaces subject to two leases, X must treat the portion of the building structure and the structural components subject to each lease as a separate unit of property under paragraph (e)(2)(v)(A) of this section. As provided under paragraph (e)(2)(v)(B) of this section, an amount is paid for an improvement to a leased unit of property, if it results in an improvement to the leased portion of the building structure or the associated portion of any designated building system subject to each lease. Under paragraphs (e)(2)(v)(B)(*1*) and (e)(2)(ii)(B)(*1*) of this section, X must treat the HVAC unit associated with one leased office space as a building system of that leased space and the HVAC unit associated with the second leased office space as a building system of that second leased space. Thus, under paragraph (e)(2)(v)(B) of this section, if the amount paid by X for work on the HVAC unit in one leased space results in an improvement (for example, a betterment) to the HVAC system that is part of that one leased space, then X must treat the amount as an improvement to that one unit of leased property.

Example 14. Leased property; personal property. X is engaged in the business of transporting passengers on private jet aircraft. To conduct its business, X leases several aircraft from Y. Assume that each aircraft is not plant property or a network asset. Under paragraph (e)(3)(iv) of this section (referencing paragraph (e)(3)(i) of this section), X must treat all of the components of each leased aircraft that are functionally interdependent as a single unit of property. Thus, X must treat each leased aircraft as a single unit of property.

Example 15. Improvement property. (i) X is a retailer of consumer products. In Year 1, X purchases a building from Y, which X intends to use as a retail sales facility. Under paragraph (e)(2)(i) of this section, X must treat the building and its structural components as a single unit of property. As provided under paragraph (e)(2)(ii) of this section, an amount is paid for an improvement to a building if it results in an improvement to the building structure or any designated building system.

(ii) In Year 2, X pays an amount to construct an extension to the building to be used for additional warehouse space. Assume that the extension involves the addition of walls, floors, roof, and doors, but does not include the addition or extension of any building systems described in paragraph (e)(2)(ii)(B) of this section. Also assume that the amount paid to build the extension results in a betterment to the building structure under paragraph (h) of this section, and is therefore treated as an amount paid for an improvement to the entire building under paragraph (e)(2)(ii) of this section. Accordingly, X capitalizes the amount paid as an improvement to the building under paragraph (d) of this section. Under paragraph (e)(4) of this section, the extension is not a unit of property separate from the building, the unit of property improved. Thus, to determine whether any future expenditure constitutes an improvement to the building under paragraph (e)(2)(ii), X must determine whether the expenditure constitutes an improvement to the building structure, including the building extension, or any of the designated building systems.

Example 16. Personal property; additional rules. X is engaged in the business of transporting freight throughout the United States. To conduct its business, X owns a fleet of truck tractors and trailers. Each tractor and trailer is comprised of various components, including tires. X purchased a truck tractor with all of its components, including tires. The tractor tires have an average useful life to X of more than one year. At the time X placed the tractor in service, it treated the tractor tires as a separate asset for depreciation purposes under section 168. X properly treated the tractor (excluding the cost of the tires) as 3-year property and the tractor tires as 5-year property under section 168(e). Because X's tractor is property other than a building, the initial units of property for the tractor are determined under the general rule in paragraph (e)(3)(i) of this section, and are comprised of all the components that are functionally interdependent. Under this rule, X must treat the tractor, including its tires, as a single unit of property because the tractor and the tires are functionally interdependent (that is, the placing in service of the tires is dependent upon the placing in service of the tractor). However, under paragraph (e)(5)(i) of this section, X must treat the tractor and tires as separate units of property because X properly treated the tires as being within a different class of property under section 168(e).

Example 17. Additional rules; change in subsequent year. X is engaged in the business of leasing nonresidential real property to retailers. In Year 1, X acquired and placed in service a building for use in its retail leasing operation. In Year 5, in order to accommodate the needs of a new lessee, X incurred costs to improve the building structure. X capitalized the costs of the improvement under paragraph (d) of this section and depreciated the improvement in accordance with section 168(i)(6) as nonresidential real property under section 168(e). In Year 7, X determined that the structural improvement made in Year 5 qualified under section 168(e)(8) as qualified retail improvement property and, therefore, is 15-year property under section 168(e). In Year 5, X changed its method of accounting to use a 15-year recovery period for the improvement. Under the additional rule of paragraph (e)(5)(ii) of this section, in Year 7, X must treat the improvement as a unit of property separate from the building.

Example 18. Additional rules; change in subsequent year. In Year 1, X acquired and placed in service a building and parking lot for use in its retail operations. Under § 1.263(a)–2T of the regulations, X capitalized the cost of the building and the parking lot and began depreciating the building and the parking lot as nonresidential real property under section 168(e). In Year 3, X completed a cost segregation study under which it properly determined that the parking lot qualifies as 15-year property under section 168(e). In Year 3, X changed its method of accounting to use a 15-year recovery period and the 150-percent declining balance method of depreciation for the parking lot. Under the additional rule of paragraph (e)(5)(ii) of this section, in Year 3, X must treat the parking lot as a unit of property separate from the building.

Example 19. Additional rules; change in subsequent year. In Year 1, X acquired and placed in service a building for use in its manufacturing business. X capitalized the costs allocable to the building's wiring separately from the building and depreciated the wiring as 7-year property under section 168(e). X capitalized the cost of the building and all other structural components of the building and began depreciating them as nonresidential real property under section 168(e). In Year 3, X completed a cost segregation study under which it properly determined that the wiring is a structural component of the building and, therefore, should have been depreciated as nonresidential real property. In Year 3, X changed its method of accounting to treat the wiring as nonresidential real property. Under the additional rule of paragraph (e)(5)(ii) of this section, in Year 3, X must change the unit of property for the wiring in a manner that is consistent with the change in treatment for depreciation purposes. Therefore, X must change the unit of property for the wiring to treat it as a structural component of the building, and as part of the building unit of property, in accordance with paragraph (e)(2)(i) of this section.

(f) *Special rules for determining improvement costs*—(1) *Improvements to leased property*—(i) *In general.* This paragraph (f)(1) provides the exclusive rules for determining whether amounts paid by a taxpayer are for the improvement to a unit of leased property and must be capitalized. In the case of a leased building or a leased portion of a building, an amount results in an improvement to a unit of leased property if it results in an improvement to any of the properties designated under paragraph (e)(2)(ii) of this section (for lessor improvements) or under paragraph (e)(2)(v)(B) of this section (for lessee improvements except as provided in paragraph (f)(ii)(B) of this section). Section 1.263(a)-4 of the regulations does not apply to amounts paid for improvements to units of leased property or to amounts paid for the acquisition or production of leasehold improvement property.

(ii) *Lessee improvements*—(A) *Requirement to capitalize.* A taxpayer lessee must capitalize the aggregate of related amounts that it pays to improve (as defined under paragraph (d) of this section) a unit of leased property except to the extent that section 110 applies to a construction allowance received by the lessee for the purpose of such improvement or where the improvement constitutes a substitute for rent. See § 1.61–8(c) for the treatment of lessee expenditures that constitute a substitute for rent. A taxpayer lessee must also capitalize the aggregate of related amounts that a lessor pays to improve (as defined under paragraph (d) of this section) a unit of leased property if the lessee is the owner of the improvement except to the extent that section 110 applies to a construction allowance received by the lessee for the purpose of such improvement. An amount paid for a lessee improvement under this paragraph (f)(1)(ii)(A) is treated as an amount paid to acquire or produce a unit of real or personal property under § 1.263(a)-2T(d)(1) of the regulations. See paragraph (e)(2)(v) of this section for the unit of property for a leased building and paragraph (e)(3)(iv) of this section for the unit of property for leased real or personal property other than a building.

(B) *Unit of property for lessee improvements.* An amount capitalized as a lessee improvement under paragraph (f)(1)(ii)(A) of this section comprises a unit of property separate from the leased property being improved. However, an amount that a lessee pays to improve (as defined under paragraph (d) of this section) a lessee improvement under paragraph (f)(1)(ii)(A) is not a unit of property separate from such lessee improvement.

(iii) *Lessor improvements*—(A) *Requirement to capitalize.* A taxpayer lessor must capitalize the aggregate of related amounts that it pays directly, or indirectly through a construction allowance to the lessee, to improve (as defined in paragraph (d) of this section) a unit of leased property where the lessor is the owner of the improvement or to the extent that section 110 applies to the construction allowance. A lessor must also capitalize the aggregate of related amounts that the lessee pays to improve a unit of property (as defined in paragraph (e) of this section) where the lessee's improvement constitutes a substitute for rent. See § 1.61–8(c) for treatment of expenditures by lessees that constitute a substitute for rent. Amounts capitalized by the lessor under this paragraph (f)(1)(iii)(A) may not be capitalized by the lessee. See paragraphs (e)(2) of this section for the unit of property for a building and paragraph (e)(3) of this section for the unit of property for real or personal property other than a building.

(B) *Unit of property for lessor improvements.* An amount capitalized as a lessor improvement under paragraph (f)(1)(iii)(A) of this section is not a unit of property separate from the unit of property improved. See paragraph (e)(4) of this section.

(iv) *Examples.* The application of this paragraph (f)(1) is illustrated by the following examples, in which it is assumed that section 110 does not apply to the lessee.

Example 1. Lessee improvements; additions to building. (i) T is a retailer of consumer products. In Year 1, T leases a building from L, which T intends to use as a retail sales facility. The leased building consists of the building structure under paragraph (e)(2)(ii)(A) of this section and various building systems under paragraph (e)(2)(ii)(B) of this section, including a plumbing system, an electrical system, and an HVAC system. Under the terms of the lease, T is permitted to improve the building at its own expense. Under paragraph (e)(2)(v)(A) of this section, because T leases the entire building, T must treat the leased building and its structural components as a single unit of property. As provided under paragraph (e)(2)(v)(B)(1) of this section, an amount is paid for an improvement to the entire leased building if it results in an improvement to the leased building structure or to any building system within the leased building. Therefore, under paragraphs (e)(2)(v)(B)(1) and (e)(2)(ii) of this section, if T pays an amount that improves the building structure, the plumbing system, the electrical system, or the HVAC system, then T must treat this amount as an improvement to the entire leased building.

(ii) In Year 2, T pays an amount to construct an extension to the building to be used for additional warehouse space. Assume that this amount results in a betterment (as defined under paragraph (h) of this section) to T's leased building structure and does not affect any building systems. Accordingly, the amount that T pays for the building extension results in an improvement to the leased building structure, and thus, under paragraph (e)(2)(v)(B)(*1*) of this section, is treated as an improvement to the entire leased building under paragraph (d) of this section. Because T, the lessee, paid an amount to improve a unit of leased property, T is required to capitalize the amount paid for the building extension under paragraph (f)(1)(ii)(A) of this section. In addition, paragraph (f)(1)(ii)(A) of this section requires T to treat the amount paid for the improvement as the acquisition or production of a unit of property (leasehold improvement property) under § 1.263(a)–2T(d)(1). Moreover, under paragraph (f)(1)(ii)(B) of this section, the building extension is a unit of property separate from the unit of leased property (the building and its structural components).

(iii) In Year 5, T pays an amount to add a larger door to the building extension that it constructed in Year 2 in order to accommodate the loading of larger products into the warehouse space. Assume that the amount paid to add the larger door results in a betterment under paragraph (h) of this section to the building structure extension, the unit of property under paragraph (f)(1)(ii)(B) of this section. As a result, T must capitalize the amounts paid to add the larger door as an improvement to T's unit of property (the building extension) under paragraph (d) of this section. In addition, because the amount that T paid to add the larger door is for an improvement to the building extension (a lessee improvement under paragraph (f)(1)(ii)(A)), the larger door is not a unit of property separate from the unit of property improved. See paragraphs (e)(4) and (f)(1)(ii)(B) of this section.

Example 2. Lessee improvements; additions to certain structural components of buildings. (i) Assume the same facts as *Example 1* except that in Year 2, T also pays an amount to construct an extension of the HVAC system into the building extension. Assume that the extension is a betterment under paragraph (h) of this section to the leased HVAC system (a building system under paragraph (e)(2)(ii)(B)(*1*) of this section). Accordingly, the amount that T pays for the extension of the HVAC system results in an improvement to a leased building system, the HVAC system, and thus, under paragraph (e)(2)(v)(B)(*1*) of this section, is treated as an improvement to the entire leased building under paragraph (d) of this section. Because T, the lessee, incurs costs to improve a unit of leased property, T is required to capitalize the costs of the improvement under paragraph (f)(1)(ii)(A) of this section. Under paragraph (f)(1)(ii)(B), the extension to the leased HVAC is a unit of property separate from the unit of leased property (the leased building and its structural components). In addition, under paragraph (f)(1)(ii)(A) of this section, T must treat the amount paid for the HVAC extension as the acquisition and production of a unit of property under § 1.263(a)–2T(d)(1).

(ii) In Year 5, T pays an amount to add an additional chiller to the portion of the HVAC system that it constructed in Year 2 in order to accommodate the climate control requirements for new product offerings. Assume that the amount paid for the chiller results in a betterment under paragraph (h) of this section to the HVAC system extension, the unit of property under paragraph (f)(1)(ii)(B) of this section. Accordingly, T must capitalize the amount paid to add the chiller as an improvement to T's unit of property (the HVAC system extension) under paragraph (d) of this section. In addition, because the amount that T paid to add the chiller is for an improvement to the HVAC system extension (a lessee improvement under paragraph (f)(1)(ii)(A) of this section), the chiller is not a unit of property separate from the unit of property improved. See paragraphs (f)(1)(ii)(B) and (e)(4) of this section.

Example 3. Lessor Improvements; additions to building. (i) T is a retailer of consumer products. In Year 1, T leases a building from L, which T intends to use as a retail sales facility. Pursuant to the lease, L provides a construction allowance to T, which T intends to use to construct an extension to the retail sales facility for additional warehouse space. Assume that the amount paid for any improvement to the building does not exceed the construction allowance and that L is treated as the owner of any improvement to the building. Under paragraph (e)(2)(i) of this section, L must treat the leased building and its structural components as a single unit of property. As provided under paragraph (e)(2)(ii) of this section, an amount paid is for an improvement to the building if it results in an improvement to the building structure or to any building system.

(ii) In Year 2, T uses L's construction allowance to construct an extension to the leased building to provide additional warehouse space in the building. Assume that the extension is a betterment (as defined under paragraph (h) of this section) to the building structure, and therefore, the amount paid for the extension results in an improvement to the building structure under paragraph (d) of this section. Under paragraph (f)(1)(iii)(A) of this section, L, the lessor and owner of the improvement, must capitalize the amounts paid to T to construct the extension to the retail sales facility. T is not permitted to capitalize the amounts paid for the lessor-owned improvement. Finally, under paragraph (f)(1)(iii)(B) of this section, the extension to L's building is not a unit of property separate from the building and its structural components.

Example 4. Lessee property; personal property added to leased building. T is a retailer of consumer products. T leases a building from L, which T intends to use as a retail sales facility. Pursuant to the lease, L provides a construction allowance to T, which T uses to acquire and construct partitions for fitting rooms, counters, and shelving. Assume that each partition, counter, and shelving unit is a unit of property under paragraph (e)(3) of this section. Assume that for federal income tax purposes T is treated as the owner of any personal property that it acquires or constructs with the construction allowance and that the amounts paid for acquisition or construction of any personal property used in the leased property do not constitute a substitute for rent. T's expenditures for the partitions, counters, and shelving are not improvements to the leased property under paragraph (d) of this section, but rather constitute amounts paid to acquire or produce separate units of personal property under § 1.263(a)–2T.

Example 5. Lessor property; buildings on leased property. L is the owner of a parcel of unimproved real property that L leases to T. Pursuant to the lease, L provides a construction allowance to T of $500,000, which T agrees to use to construct a building costing not more than $500,000 on the leased real property and to lease the building from L after it is constructed. Assume that for Federal income tax purposes, L is treated as the owner of the building that T will construct. T uses the $500,000 to construct the building as required under the lease. The building consists of the building structure and the following building systems: (1) A plumbing system; (2) an electrical system; and (3) an HVAC system. Because L provides a construction allowance to T to construct a building, the total cost of the building equals $500,000, and L is treated as the owner of the building, under paragraph (f)(1)(iii)(A) of this section L must capitalize the amounts that it pays indirectly to acquire and produce the building under § 1.263(a)–2T(d)(1). Under paragraph (e)(2)(i) of this section, L must treat the building and its structural components as a single unit of property. Under paragraph (f)(1)(iii)(A) of this section, T, the lessee, may not capitalize the amounts paid (with the construction allowance received from L) for construction of the building.

Example 6. Lessee contribution to construction costs. Assume the same facts as in *Example 5,* except T spends $600,000 to construct the building. T uses the $500,000 construction allowance provided by L plus $100,000 of its own funds to construct the building that L will own pursuant to the lease. Also assume that the additional $100,000 that T incurs is not a substitute for rent. For the reasons discussed in *Example 5,* L must capitalize the $500,000 it paid T to construct the building under § 1.263(a)–2T(d)(1). In addition, because T spends its own funds to complete the building, T has a depreciable interest of $100,000 in the building and must capitalize the $100,000 it paid to construct the building as a leasehold improvement under § 1.263(a)–2T(d)(1) of the regulations. Under paragraph (e)(2)(i) of this section, L must treat the building as a single unit of property to the extent of its depreciable interest of $500,000 In addition, under paragraph (e)(2)(v)(A) of this section, T must also treat the building as a single unit of property to the extent of its depreciable interest of $100,000.

(2) *Compliance with regulatory requirements.* For purposes of this section, a Federal, state, or local regulator's requirement that a taxpayer perform certain repairs or maintenance on a unit of property to continue operating the property is not relevant in

determining whether the amount paid improves the unit of property.

(3) *Certain costs incurred during an improvement*—(i) *In general.* A taxpayer must capitalize all the direct costs of an improvement and all the indirect costs (including, for example, otherwise deductible repair or component removal costs) that directly benefit or are incurred by reason of an improvement in accordance with the rules under section 263A. Therefore, indirect costs that do not directly benefit and are not incurred by reason of an improvement are not required to be capitalized under section 263(a), regardless of whether they are made at the same time as an improvement.

(ii) *Exception for individuals' residences.* A taxpayer who is an individual may capitalize amounts paid for repairs and maintenance that are made at the same time as capital improvements to units of property not used in the taxpayer's trade or business or for the production of income if the amounts are paid as part of a remodeling of the taxpayer's residence.

(4) *Aggregate of related amounts.* For purposes of paragraph (d) of this section, the aggregate of related amounts paid to improve a unit of property may be incurred over a period of more than one taxable year. Whether amounts are related to the same improvement depends on the facts and circumstances of the activities being performed and whether the costs are incurred by reason of a single improvement or directly benefit a single improvement.

(g) *Safe harbor for routine maintenance on property other than buildings*—(1) *In general.* An amount paid for routine maintenance performed on a unit of property other than a building or a structural component of a building is deemed not to improve that unit of property. Routine maintenance is the recurring activities that a taxpayer expects to perform as a result of the taxpayer's use of the unit of property to keep the unit of property in its ordinarily efficient operating condition. Routine maintenance activities include, for example, the inspection, cleaning, and testing of the unit of property, and the replacement of parts of the unit of property with comparable and commercially available and reasonable replacement parts. The activities are routine only if, at the time the unit of property is placed in service by the taxpayer, the taxpayer reasonably expects to perform the activities more than once during the class life (as defined in paragraph (g)(4) of this section) of the unit of property. Among the factors to be considered in determining whether a taxpayer is performing routine maintenance are the recurring nature of the activity, industry practice, manufacturers' recommendations, the taxpayer's experience, and the taxpayer's treatment of the activity on its applicable financial statement (as defined in paragraph (b)(4) of this section). With respect to a taxpayer that is a lessor of a unit of property, the taxpayer's use of the unit of property includes the lessee's use of the unit of property.

(2) *Rotable and temporary spare parts.* Except as provided in paragraph (g)(3) of this section, for purposes of paragraph (g)(1) of this section, amounts paid for routine maintenance include routine maintenance performed on (and with regard to) rotable and temporary spare parts. But see § 1.162–3T(a)(3), which provides generally that rotable and temporary spare parts are used or consumed by the taxpayer in the taxable year in which the taxpayer disposes of the parts.

(3) *Exceptions.* Routine maintenance does not include the following:

(i) Amounts paid for the replacement of a component of a unit of property and the taxpayer has properly deducted a loss for that component (other than a casualty loss under § 1.165–7).

(ii) Amounts paid for the replacement of a component of a unit of property and the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component.

(iii) Amounts paid for the repair of damage to a unit of property for which the taxpayer has taken a basis adjustment as a result of a casualty loss under section 165, or relating to a casualty event described in section 165.

(iv) Amounts paid to return a unit of property to its ordinarily efficient operating condition, if the property has deteriorated to a state of disrepair and is no longer functional for its intended use.

(v) Amounts paid for repairs, maintenance, or improvement of rotable and temporary spare parts to which the taxpayer applies the optional method of accounting for rotable and temporary spare parts under § 1.162–3T(e).

(4) *Class life.* The class life of a unit of property is the recovery period prescribed for the property under sections 168(g)(2) and (3) for purposes of the alternative depreciation system, regardless of whether the property is depreciated under section 168(g). For purposes of determining class life under this section, section 168(g)(3)(A) (relating to tax-exempt use property subject to lease) does not apply. If the unit of property is comprised of more than one component with different class lives, then the class life of the unit of property is deemed to be the same as the component with the longest class life.

(5) *Examples.* The following examples illustrate the rules of this paragraph (g). Unless otherwise stated, assume that X has not applied the optional method of accounting for rotable and temporary spare parts under § 1.162–3T(e):

Example 1. Routine maintenance on component. (i) X is a commercial airline engaged in the business of transporting passengers and freight throughout the United States and abroad. To conduct its business, X owns or leases various types of aircraft. As a condition of maintaining its airworthiness certification for these aircraft, X is required by the Federal Aviation Administration (FAA) to establish and adhere to a continuous maintenance program for each aircraft within its fleet. These programs, which are designed by X and the aircraft's manufacturer and approved by the FAA, are incorporated into each aircraft's maintenance manual. The maintenance manuals require a variety of periodic maintenance visits at various intervals. One type of maintenance visit is an engine shop visit (ESV), which X expects to perform on its aircraft engines approximately every 4 years in order to keep its aircraft in its ordinarily efficient operating condition. In Year 1, X purchased a new aircraft, which included four new engines attached to the airframe. The four aircraft engines acquired with the aircraft are not materials or supplies under § 1.162–3T(c)(1)(i) because they are acquired as part of a single unit of property, the aircraft. In Year 5, X performs its first ESV on the aircraft engines. The ESV includes disassembly, cleaning, inspection, repair, replacement, reassembly, and testing of the engine and its component parts. During the ESV, the engine is removed from the aircraft and shipped to an outside vendor who performs the ESV. If inspection or testing discloses a discrepancy in a part's conformity to the specifications in X's maintenance program, the part is repaired, or if necessary, replaced with a comparable and commercially available and reasonable replacement part. After the ESVs, the engines are returned to X to be reinstalled on another aircraft or stored for later installation. Assume that the unit of property for X's aircraft is the entire aircraft, including the aircraft engines, and that the class life for X's aircraft is 12 years. Assume that none of the exceptions set out in paragraph (g)(3) of this section applies to the costs of performing the ESVs.

(ii) Because the ESVs involve the recurring activities that X expects to perform as a result of its use of the aircraft to keep the aircraft in ordinarily efficient operating condition, and consist of maintenance activities that X expects to perform more than once during the 12 year class life of the aircraft, X's ESVs are within the routine maintenance safe harbor under paragraph (g) of this section. Accordingly, the amounts paid for the ESVs are deemed not to improve the aircraft and are not required to be capitalized under paragraph (d) of this section.

Example 2. Routine maintenance after class life. Assume the same facts as in *Example 1,* except that in year 15, X pays amounts to perform an ESV on one of the original aircraft engines, after the end of the class life of the aircraft. Because this ESV involves the same routine maintenance activities that were performed on aircraft engines in *Example 1,* this ESV also is within the routine maintenance safe harbor under paragraph (g) of this section. Accordingly, the amounts paid for this ESV, even though performed after the class life of the aircraft, are deemed not to improve the aircraft and are not required to be capitalized under paragraph (d) of this section.

Example 3. Routine maintenance on rotable spare parts. (i) Assume the same facts as in *Example 1,* except that in addition to the four engines purchased as part of the aircraft, X separately purchases four additional new engines that X intends to use in its aircraft fleet to avoid operational downtime when ESVs are required to be performed on the engines previously installed on an aircraft. Later in Year 1, X installs these four engines on an aircraft in its fleet. In Year 5, X performs the first ESVs on these four engines. Assume that these ESVs involve the same routine maintenance activities that were performed on the engines in *Example 1,* and that none of the exceptions set out in paragraph (g)(3) of this section apply to these ESVs. After the ESVs were performed, these engines were reinstalled on other aircraft or stored for later installation.

(ii) The additional aircraft engines are rotable spare parts because they were acquired separately from the aircraft, they are removable from the aircraft, and are repaired and reinstalled on other aircraft or stored for later installation. *See* § 1.162–3T(c)(2) (definition of rotable and temporary spare parts). The class life of an engine is the same as the airframe, 12 years. Because the ESVs involve the recurring activities that X expects to perform as a result of its use of the engines to keep the engines in ordinarily efficient operating condition, and consist of maintenance activities that X expects to perform more than once during the 12 year class life of the engine, the ESVs fall within the routine maintenance safe harbor under paragraph (g) of this section. Accordingly, the amounts paid for the ESVs for the four additional engines are deemed not to improve these engines and are not required to be capitalized under paragraph (d) of this section. For the treatment of amounts paid to acquire the engines, see § 1.162–3T(a).

Example 4. Routine maintenance resulting from prior owner's use. (i) In January, Year 1, X purchases a used machine for use in its manufacturing operations. Assume that the machine is the unit of property and has a class life of 10 years. X places the machine in service in January, Year 1, and at that time, X expects to perform manufacturer recommended scheduled maintenance on the machine approximately every three years. The scheduled maintenance includes the cleaning and oiling of the machine, the inspection of parts for defects, and the replacement of minor items such as springs, bearings, and seals with comparable and commercially available and reasonable replacement parts. At the time X purchased the machine, the machine was approaching the end of a three-year scheduled maintenance period. As a result, in February, Year 1, X pays amounts to perform the manufacturer recommended scheduled maintenance. Assume that none of the exceptions set out in paragraph (g)(3) of this section apply to the amounts paid for the scheduled maintenance.

(ii) The majority of X's costs do not qualify under the routine maintenance safe harbor in paragraph (g) of this section because the costs were incurred primarily as a result of the prior owner's use of the property and not X's use. X acquired the machine just before it had received its three-year scheduled maintenance. Accordingly, the amounts paid for the scheduled maintenance resulted from the prior owner's, and not the taxpayer's, use of the property and must be capitalized if those amounts result in a betterment under paragraph (h) of this section, including the amelioration of a material condition or defect, or otherwise result in an improvement under paragraph (d) of this section. See also section 263A and the regulations thereunder for the requirement to capitalize indirect costs (including otherwise deductible repair costs) that directly benefit or are incurred by reason of production activities.

Example 5. Routine maintenance resulting from new owner's use. Assume the same facts as in *Example 4*, except that after X pays amounts for the maintenance in Year 1, X continues to operate the machine in its manufacturing business. In Year 4, X pays amounts to perform the next scheduled manufacturer recommended maintenance on the machine. Assume that the scheduled maintenance activities performed are the same as those performed in *Example 4* and that none of the exceptions set out in paragraph (g)(3) of this section apply to the amounts paid for the scheduled maintenance. Because the scheduled maintenance performed in Year 4 involves the recurring activities that X performs as a result of its use of the machine, keeps the machine in an ordinarily efficient operating condition, and consists of maintenance activities that X expects to perform more than once during the 10 year class life of the machine, X's scheduled maintenance costs are within the routine maintenance safe harbor under paragraph (g) of this section. Accordingly, the amounts paid for the scheduled maintenance in Year 4 are deemed not to improve the machine and are not required to be capitalized under paragraph (d) of this section. But see section 263A and the regulations thereunder for the requirement to capitalize indirect costs (including otherwise deductible repair costs) that directly benefit or are incurred by reason of production activities.

Example 6. Routine maintenance; replacement of substantial structural part. X is in the business of producing commercial products for sale. As part of the production process, X places raw materials into lined containers in which a chemical reaction is used to convert raw materials into the finished product. The lining is a substantial structural part of the container, and comprises 60 percent of the total physical structure of the container. Assume that each container, including its lining, is the unit of property and that a container has a class life of 12 years. At the time that X placed the container into service, X was aware that approximately every three years, X would be required to replace the lining in the container with comparable and commercially available and reasonable replacement materials. At the end of that period, the container will continue to function, but will become less efficient and the replacement of the lining will be necessary to keep the container in an ordinarily efficient operating condition. In Year 1, X acquired 10 new containers and placed them into service. In Year 4, Year 7, Year 9, and Year 12, X pays amounts to replace the containers' linings with comparable and commercially available and reasonable replacement parts. Assume that none of the exceptions set out in paragraph (g)(3) of this section apply to the amounts paid for the replacement linings. Because the replacement of the linings involves recurring activities that X expects to perform as a result of its use of the containers to keep the containers in their ordinarily efficient operating condition, and consists of maintenance activities that X expects to perform more than once during the 12 year class lives of the containers, X's lining replacement costs are within the routine maintenance safe harbor under paragraph (g) of this section. Accordingly, the amounts that X paid for the replacement of the container linings are deemed not to improve the containers and are not required to be capitalized under paragraph (d) of this section. But see section 263A and the regulations thereunder for the requirement to capitalize indirect costs (including otherwise deductible repair costs) that directly benefit or are incurred by reason of production activities.

Example 7. Routine maintenance once during class life. X is a Class I railroad that owns a fleet of freight cars. Assume that a freight car, including all its components, is a unit of property and has a class life of 14 years. At the time that X places a freight car into service, X expects to perform cyclical reconditioning to the car every 8 to 10 years in order to keep the freight car in ordinarily efficient operating condition. During this reconditioning, X pays amounts to disassemble, inspect, and recondition or replace components of the freight car with comparable and commercially available and reasonable replacement parts. Ten years after X places the freight car in service, X pays amounts to perform a cyclical reconditioning on the car. Because X expects to perform the reconditioning only once during the 14 year class life of the freight car, the amounts X pays for the reconditioning do not qualify for the routine maintenance safe harbor under paragraph (g) of this section. Accordingly, X must capitalize the amounts paid for the reconditioning of the freight car if these amounts result in an improvement under paragraph (d) of this section.

Example 8. Routine maintenance on non-rotable part. X is a towboat operator that owns and leases a fleet of towboats. Each towboat is equipped with two dieselpowered engines. Assume that each towboat, including its engines, is the unit of property and that a towboat has a class life of 18 years. At the time that X places its towboats into service, X is aware that approximately every three to four years, X will need to perform scheduled maintenance on the two towboat engines to keep the engines in their ordinarily efficient operating condition. This maintenance is completed while the engines are attached to the towboat and involves the cleaning and inspecting of the engines to determine which parts are within acceptable operating tolerances and can continue to be used, which parts must be reconditioned to be brought back to acceptable tolerances, and which parts must be replaced. Engine parts replaced during these procedures are replaced with comparable and commercially available and reasonable replacement parts. Assume the towboat engines are not rotable spare parts under § 1.162–3T(c)(2). In Year 1, X acquired a new towboat, including its two engines, and placed the towboat into service. In Year 5, X pays amounts to perform scheduled maintenance on both engines in the towboat. Assume that none of the exceptions set out in paragraph (g)(3) of this section apply to the scheduled maintenance costs. Because the scheduled maintenance involves recurring activities that X expects to perform more than once during the 18 year class life of the towboat, the maintenance results from X's use of the towboat and the maintenance is performed to keep the towboat in an ordinarily efficient operating condition, the scheduled maintenance on X's towboat is within the routine maintenance safe harbor under paragraph (g) of this section. Accordingly, the amounts paid for the scheduled maintenance to its towboat engines in Year 5 are deemed not to improve the towboat and are not required to be capitalized under paragraph (d) of this section.

Example 9. Routine maintenance with betterments. Assume the same facts as *Example 8,* except that in Year 9, X's towboat engines are due for another scheduled maintenance visit. At this time, X decides to upgrade the engines to increase their horsepower and propulsion, which would permit the towboats to tow heavier loads. Accordingly, in Year 9, X pays amounts to perform many of the same activities that it would perform during the typical scheduled maintenance activities such as cleaning, inspecting, reconditioning, and replacing minor parts, but at the same time, X incurs costs to upgrade certain engine parts to increase the towing capacity of the boats in excess of the capacity of the boats when X placed them in service. Both the scheduled maintenance procedures and the replacement of parts with new and upgraded parts are necessary to increase the horsepower of the engines and the towing capacity of the boat. Thus, the work done on the engines encompasses more than the recurring activities that X expected to perform as a result of its use of the towboats and did more than keep the towboat in its ordinarily efficient operating condition. In addition, under paragraph (f)(3)(i) of this section, the scheduled maintenance procedures directly benefit the upgrades. Therefore, the amounts that X paid in Year 9 for the maintenance and upgrade of the engines do not qualify for the routine maintenance safe harbor described under paragraph (g) of this section. These amounts must be capitalized if they result in a betterment under paragraph (h) of this section, including a material increase in the capacity of the towboat, or otherwise result in an improvement under paragraph (d) of this section.

Example 10. Exceptions to routine maintenance. X owns and operates a farming and cattle ranch with an irrigation system that provides water for crops. Assume that each canal in the irrigation system is a single unit of property and has a class life of 20 years. At the time X placed the canals into service, X expected to have to perform major maintenance on the canals every 3 years to keep the canals in their ordinarily efficient operating condition. This maintenance includes draining the canals, and then cleaning, inspecting, repairing, reconditioning or replacing parts of the canal with comparable and commercially available and reasonable replacement parts. X placed the canals into service in Year 1 and did not perform any maintenance on the canals until Year 6. At that time, the canals had fallen into a state of disrepair and no longer functioned for irrigation. In Year 6, X pays amounts to drain the canals, and do extensive cleaning, repairing, reconditioning, and replacing parts of the canals with comparable and commercially available and reasonable replacement parts. Although the work performed on X's canals was similar to the activities that X expected to perform, but did not perform, every three years, the costs of these activities do not fall within the routine maintenance safe harbor. Specifically, under paragraph (g)(3)(iv) of this section, routine maintenance does not include activities that return a unit of property to its former ordinary efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use. Accordingly, amounts that X pays for work performed on the canals in Year 6 must be capitalized if they result in improvements under paragraph (d) of this section (for example, restorations under paragraph (i) of this section).

(h) *Capitalization of betterments*—(1) *In general.* A taxpayer must capitalize amounts paid that result in the betterment of a unit of property. An amount paid results in the betterment of a unit of property only if it—

(i) Ameliorates a material condition or defect that either existed prior to the taxpayer's acquisition of the unit of property or arose during the production of the unit of property, whether or not the taxpayer was aware of the condition or defect at the time of acquisition or production;

(ii) Results in a material addition (including a physical enlargement, expansion, or extension) to the unit of property; or

(iii) Results in a material increase in capacity (including additional cubic or square space), productivity, efficiency, strength, or quality of the unit of property or the output of the unit of property.

(2) *Betterments to buildings.* In the case of a building, an amount results in a betterment to the unit of property if it results in a betterment to any of the properties designated in paragraphs (e)(2)(ii), (e)(2)(iii)(B), (e)(2)(iv)(B), or (e)(2)(v)(B) of this section.

(3) *Application of general rule*—(i) *Facts and circumstances.* To determine whether an amount paid results in a betterment described in paragraph (h)(1) of this section, it is appropriate to consider all the facts and circumstances including, but not limited to, the purpose of the expenditure, the physical nature of the work performed, the effect of the expenditure on the unit of property, and the taxpayer's treatment of the expenditure on its applicable financial statement (as described in paragraph (b)(4) of this section).

(ii) *Unavailability of replacement parts.* If a taxpayer needs to replace part of a unit of property that cannot practicably be replaced with the same type of part (for example, because of technological advancements or product enhancements), the replacement of the part with an improved, but comparable, part does not, by itself, result in a betterment to the unit of property.

(iii) *Appropriate comparison*—(A) *In general.* In cases in which a particular event necessitates an expenditure, the determination of whether an expenditure results in a betterment of the unit of property is made by comparing the condition of the property immediately after the expenditure with the condition of the property immediately prior to the circumstances necessitating the expenditure.

(B) *Normal wear and tear.* If the expenditure is made to correct the effects of normal wear and tear to the unit of property (including the amelioration of a condition or defect that existed prior to the taxpayer's acquisition of the unit of property resulting from normal wear and tear), the condition of the property immediately prior to the circumstances necessitating the expenditure is the condition of the property after the last time the taxpayer corrected the effects of normal wear and tear (whether the amounts paid were for maintenance or improvements) or, if the taxpayer has not previously corrected the effects of normal wear and tear, the condition of the property when placed in service by the taxpayer.

(C) *Particular event.* If the expenditure is made as a result of a particular event, the condition of the property immediately prior to the circumstances necessitating the expenditure is the condition of the property immediately prior to the particular event.

(4) *Examples.* The following examples illustrate the application of this paragraph (h) only and do not address whether capitalization is required under another provision of this section or another provision of the Internal Revenue Code (for example, section 263A):

Example 1. Amelioration of pre-existing material condition or defect. In Year 1, X purchases a store located on a parcel of land that contained underground gasoline storage tanks left by prior occupants. Assume that the parcel of land is the unit of property. The tanks had leaked, causing soil contamination. X is not aware of the contamination at the time of purchase. In Year 2, X discovers the contamination and incurs costs to remediate the soil. The remediation costs result in a betterment to the land under paragraph (h)(1)(i) of this section because X incurred the costs to ameliorate a material condition or defect that existed prior to X's acquisition of the land.

Example 2. Not amelioration of pre-existing condition or defect. X owns a building that was constructed with insulation that contained asbestos. The health dangers of asbestos were not widely known when the building was constructed. X determines that certain areas of asbestos-containing insulation had begun to deteriorate and could eventually pose a health risk to employees. Therefore, X pays an amount to remove the asbestos-containing insulation from the building structure and replace it with new insulation that is safer to employees, but no more efficient or effective than the asbestos insulation. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. Although the asbestos is determined to be unsafe under certain circumstances, the asbestos is not a preexisting or material defect of the building structure under paragraph (h)(1)(i) of this section. In addition, the removal and replacement of the asbestos does not result in a material addition to the building structure under paragraph (h)(1)(ii) of this section or result in a material increase in capacity, productivity, efficiency, strength, or quality of the building structure or the output of the building structure under paragraph (h)(1)(iii) of this section. Therefore, the amount paid to remove and replace the asbestos insulation does not result in a betterment to the building structure under paragraph (h) of this section.

Example 3. Not amelioration of pre-existing material condition or defect. (i) In January, Year 1, X purchased a used machine for use in its manufacturing operations. Assume that the machine is a unit of property and has a class life of 10 years. X placed the machine in service in January, Year 1 and at that time expected to perform manufacturer recommended scheduled maintenance on the machine every three years. The scheduled maintenance includes the cleaning and oiling of the machine, the inspection of parts for defects, and the replacement of minor items such as springs, bearings, and seals with comparable and commercially available and reasonable replacement parts. The scheduled maintenance does not result in any material additions or material increases in capacity, productivity, efficiency, strength or quality of the machine or the output of the machine. At the time X purchased the machine, it was approaching the end of a three-year scheduled maintenance period. As a result, in February, Year 1, X pays an amount to perform the manufacturer recommended scheduled maintenance to keep the machine in its ordinarily efficient operating condition.

(ii) The amount that X pays does not qualify under the routine maintenance safe harbor in paragraph (g) of this section because the cost primarily results from the prior owner's use of the property and not the taxpayer's use. X acquired the machine just before it had received its three-year scheduled maintenance. Accordingly, the amount that X pays for the scheduled maintenance results from the prior owner's use of the property and ameliorates conditions or defects that existed prior to X's ownership of the machine. Nevertheless, considering the facts and circumstances under paragraph (h)(2)(i) of this section, including the purpose and minor nature of the work performed, this amount does not ameliorate a material condition or defect in the machine under paragraph (h)(1)(i) of this section, result in a material addition to the machine under paragraph (h)(1)(ii) of this section, or result in a material increase in the capacity, productivity, efficiency, strength, or quality of the machine or the output of the machine under paragraph (h)(1)(iii) of this section. Therefore, X is not required to capitalize the amount paid for the scheduled maintenance as a betterment to the machine under this paragraph (h).

Example 4. Not amelioration of pre-existing material condition or defect. X purchases a used ice resurfacing machine for use in the operation of its ice skating rink. To comply with local regulations, X is required to monitor routinely the air quality in the ice skating rink. One week after X places the machine into service, during a routine air quality check, X discovers that the operation of the machine is adversely affecting the air quality in the skating rink. As a result, X pays an amount to inspect and retune the machine, which includes replacing minor components of the engine, which had worn out prior to X's acquisition of the machine. Assume the resurfacing machine, including the engine, is the unit of property. The routine maintenance safe harbor in paragraph (g) of this section does not apply to the amounts paid because the activities performed do more than return the machine to the condition that existed at the time X placed it in service. The amount that X pays to inspect, retune, and replace minor components of the ice resurfacing machine ameliorates a condition or defect that existed prior to X's acquisition of the equipment. Nevertheless, considering the facts and circumstances under paragraph (h)(3)(i) of this section, including the purpose and minor nature of the work performed, this amount does not ameliorate a material condition or defect in the machine under paragraph (h)(1)(i) of this section, result in a material addition to the machine under paragraph (h)(1)(ii) of this section, or result in a material increase in the capacity, productivity, efficiency, strength, or quality of the machine or the output of the machine under paragraph(h)(1)(iii) of this section. Therefore, X is not required to capitalize the amount paid to inspect, retune, and replace minor components of the machine as a betterment under this paragraph (h).

Example 5. Amelioration of material condition or defect. (i) X acquires a building for use in its business of providing assisted living services. Before and after the purchase, the building functions as an assisted living facility. However, at the time of the purchase, X is aware that the building is in a condition that is below the standards that X requires for facilities used in its business. Immediately after the acquisition and during the following two years, while X continues to use the building as an assisted living facility, X pays amounts for repairs, maintenance, and the acquisition of new property to bring the facility into the high-quality condition for which X's facilities are known. The work on X's building includes repairing damaged drywall, repainting, re-wallpapering, replacing windows, repairing and replacing doors; replacing and regrouting tile; repairing millwork; and repairing and replacing roofing materials. The work also involves the replacement of section 1245 property including window treatments, furniture, and cabinets. On its applicable financial statements, X capitalizes the costs of the repairs and maintenance to the building. The work that X performs affects only the building structure under paragraph (e)(2)(ii)(A) of this section and does not affect any of the building systems described in paragraph (e)(2)(ii)(B) of this section. Assume that each section 1245 property is a separate unit of property.

(ii) Under paragraph (e)(2)(ii) of this section, if an amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. Considering the facts and circumstances, as required under paragraph (h)(3)(i) of this section, including the purpose of the expenditures, the effect of the expenditures on the building structure, and the treatment of the expenditures in X's applicable financial statements, the amounts that X paid for repairs and maintenance to the building structure comprises a betterment to the building structure under paragraph (h)(1)(i) of this section because the amounts ameliorate material conditions or defects that existed prior to X's acquisition of the building. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amounts paid for the betterment to the building structure as an improvement to the building and must capitalize the amounts under paragraph (d)(1) of this section. Moreover, X is required to capitalize the amounts paid to acquire and install each section 1245 property, including each window treatment, each item of furniture, and each cabinet, in accordance with § 1.263(a)–2T(d)(1).

Example 6. Not a betterment; building refresh. (i) X owns a nationwide chain of retail stores that sell a wide variety of items. To remain competitive in the industry and increase customer traffic and sales volume, X periodically refreshes the appearance and layout of its stores. The work that X performs to refresh a store consists of cosmetic and layout changes to the store's interiors and general repairs and maintenance to the store building to make the stores more attractive and the merchandise more accessible to customers. The work to each store building consists of replacing and reconfiguring a small number of display tables and racks to provide better exposure of the merchandise, making corresponding lighting relocations and flooring repairs, moving one wall to accommodate the reconfiguration of tables and racks, patching holes in walls, repainting the interior structure with a new color scheme to coordinate with new signage, replacing damaged ceiling tiles, cleaning and repairing vinyl flooring throughout the store building, and power washing building exteriors. The display tables and the racks all constitute section 1245 property. X pays amounts to refresh 50 stores during the taxable year. In its applicable financial statement, X capitalizes all the costs to refresh the store buildings and amortizes them over a 5-year period. Assume that each section 1245 property within each store is a separate unit of property. Finally, assume that the work does not ameliorate any material conditions or defects that existed when X acquired the store buildings or result in any material additions to the store buildings.

(ii) Under paragraph (e)(2)(ii) of this section, if an amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. Considering the facts and circumstances, as required under paragraph (h)(3)(i) of this section, including the purpose of the expenditure, the physical nature of the work performed, the effect of the expenditure on buildings' structure and systems, and the treatment of the work on X's applicable financial statements, the amounts paid for the refresh of each building do not result in material increases in capacity, productivity, efficiency, strength, or quality of the buildings' structures or any building systems as compared to the condition of the buildings' structures and systems after the previous refresh. Rather, the work performed keeps X's store buildings' structures and buildings' systems in the ordinary efficient operating condition that is necessary for X to continue to attract customers to its stores. Therefore, X is not required to treat the amounts paid for the refresh of its store buildings' structures and buildings' systems as betterments under paragraph (h)(1)(iii) of this section. However, X is required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with § 1.263(a)–2T(d)(1).

Example 7. Building refresh; limited improvement. Assume the same facts as *Example 6* except, in the course of X's refresh of its stores, X pays amounts to remove and replace the bathroom fixtures (that is, the toilets, sinks, and plumbing fixtures) with upgraded bathroom fixtures in all of the restrooms in X's retail buildings in order to update the restroom facilities. As part of the update of the restrooms, X also pays amounts to replace the floor and wall tiles that were removed or damaged in the installation of the new plumbing fixtures. Under paragraph (e)(2)(ii of this section, if any of the amounts paid result in betterments to the building structure or any building system, X must treat the amounts as an improvement to the building. Under paragraph (e)(2)(ii)(B)(*2*) of this section, the plumbing system in each of X's store buildings, including the plumbing fixtures, is a building system. X must treat the amounts paid to replace the bathroom fixtures with upgraded fixtures as a betterment because they result in a material increase in the quality of each plumbing system under paragraph (h)(1)(iii) of this section. Under paragraph (f)(3) of this section, X is required to capitalize all the indirect costs that directly benefit or are incurred by reason of the betterment, or improvement, to each plumbing system. Because the costs to remove the old plumbing fixtures and to remove and replace the bathroom tiles directly benefit and are incurred by reason of the improvement to the plumbing system, these costs must also be capitalized under paragraph (f)(3) of this section. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amounts paid for a betterment to each plumbing system as an improvement to X's retail building to which the costs relate, and must capitalize the amounts under paragraph (d)(1) of this section. However, X is not required under paragraph (f)(3) of this section to capitalize the costs described in *Example 6* to refresh the appearance and layout of its stores because those costs do not directly benefit and are not incurred by reason of the improvements to the stores' plumbing systems. Thus, X is not required to capitalize under paragraphs (f)(3) of this section any costs specified in *Example 6* for the reconfiguration, cosmetic changes, repairs, and maintenance to the other parts of X's store buildings.

Example 8. Betterment; building remodel. (i) Assume the same facts as *Example 6,* but assume that the work performed to refresh the stores directly benefits or was incurred by reason of a substantial remodel to X's store buildings. In addition to the reconfiguration, cosmetic changes, repairs, and maintenance activities performed in *Example 6,* X performs significant additional work to alter the appearance and layout of its stores in order to increase customer traffic and sales volume. First, X pays amounts to upgrade the buildings' structures as defined under (e)(2)(ii)(A). This work includes removing and rebuilding walls to move built-in changing rooms and specialty departments to different areas of the stores, replacing ceilings with acoustical tiles to reduce noise and create a more pleasant shopping environment, rebuilding the interior and exterior facades around the main doors to create a more appealing entrance, replacing conventional doors with automatic doors, and replacing carpet with ceramic flooring of different textures and styles to delineate departments and direct customer traffic. Second, X pays amounts for work on the electrical systems, which are building systems under paragraph (e)(2)(ii)(B)(*3*) of this section. Specifically, X upgrades the wiring in the buildings so that X can add video monitors and an expanded electronics department. X also removes and replaces the recessed lighting throughout the buildings with more efficient and brighter lighting. The work performed on the buildings' structures and the electrical systems includes the removal and replacement of both section 1250 and section 1245 property. In its applicable financial statement, X capitalizes all the costs incurred over a 10-year period. Upon completion of this period, X anticipates that it will have to remodel the store buildings again.

(ii) Under paragraph (e)(2)(ii) of this section, if any of the amounts paid result in a betterment to the building structure or any building system, X must treat those amounts as an improvement to the building. Considering the facts and circumstances, as required under paragraph (h)(3)(i) of this section, including the purpose of the expenditure, the physical nature of the work performed, the effect of the work on the buildings' structures and buildings' systems, and the treatment of the work on X's applicable financial statements, the amounts that X pays for the remodeling of its stores result in betterments to the buildings' structures and electrical systems under paragraph (h) of this section. Specifically, amounts paid to upgrade the wiring and to remove and replace the recess lighting throughout the stores materially increase the productivity, efficiency, and quality of X's stores' electrical systems under paragraph (h)(1)(iii) of this section. Also, the amounts paid to remove and rebuild walls, to replace ceilings, to rebuild facades, to replace doors, and replace flooring materially increase the productivity, efficiency, and quality of X's store buildings' structures under paragraph (h)(1)(iii) of this section. In addition, the amounts paid for the refresh of the store buildings described in *Example 6* must be capitalized under paragraph (f)(3)(i) of this section because these expenditures directly benefitted or were incurred by reason of the improvements to X's store buildings' structures and electrical systems. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the costs of improving the buildings' structures and systems, including the costs to refresh, as improvements to X's retail buildings and must capitalize the amounts paid for these improvements under paragraph (d)(1) of this section. Moreover, X is required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with § 1.263(a)–2T(d)(1).

Example 9. Not betterment; relocation and reinstallation of personal property. In Year 1, X purchases new cash registers for use in its retail store located in leased space in a shopping mall. Assume that each cash register is a unit of property as determined under paragraph (e)(3) of this section. In Year

1, X capitalizes the costs of acquiring and installing the new cash registers under § 1.263(a)–2T(d)(1). In Year 3, X's lease expires and X decides to relocate its retail store to a different building. In addition to various other costs, X pays $5,000 to move the cash registers and $1,000 to reinstall them in the new store. The cash registers are used for the same purposes and in the same manner that they were used in the former location. The amounts that X pays to move and reinstall the cash registers into its new store do not result in a betterment to the cash registers under paragraph (h) of this section.

Example 10. Betterment; relocation and reinstallation of manufacturing equipment. X operates a manufacturing facility in Building A, which contains various machines that X uses in its manufacturing business. X decides to expand part of its operations by relocating a machine to Building B to reconfigure the machine with additional components. Assume that the machine is a single unit of property under paragraph (e)(3) of this section. X pays amounts to disassemble the machine, to move the machine to the new location, and to reinstall the machine in a new configuration with additional components. Assume that the reinstallation, including the reconfiguration and the addition of components, results in an increase in capacity of the machine, and therefore results in a betterment to the machine under paragraph (h)(3)(iii) of this section. Accordingly, X must capitalize the costs of reinstalling the machine as an improvement to the machine under paragraph (d)(1) of this section. X is also required to capitalize the costs of disassembling and moving the machine to Building B because these costs directly benefit and are incurred by reason of the improvement to the machine under paragraph (f)(3)(i) of this section.

Example 11. Betterment; regulatory requirement. X owns a hotel that includes five feet high unreinforced terra cotta and concrete parapets with overhanging cornices around the entire roof perimeter. The parapets and cornices are in good condition. In Year 1, City passes an ordinance setting higher safety standards for parapets and cornices because of the hazardous conditions caused by earthquakes. To comply with the ordinance, X pays an amount to remove the old parapets and cornices and replace them with new ones made of glass fiber reinforced concrete, which makes them lighter and stronger than the original components. They are attached to the hotel using welded connections instead of wire supports, making them more resistant to damage from lateral movement. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. The parapets and cornices are part of the building structure as defined in paragraph (e)(2)(ii)(A) of this section. The event necessitating the expenditure was the City ordinance. Prior to the ordinance, the old parapets and cornices were in good condition, but were determined by City to create a potential hazard. After the expenditure, the new parapets and cornices materially increased the structural soundness (that is, the strength) of the hotel structure. X must treat the amount paid to remove and replace the parapets and cornices as an improvement because it results in a betterment to the building structure under paragraph (h)(1)(iii) of this section. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid for the betterment to the building structure as an improvement to the hotel building and must capitalize the amount paid under paragraph (d)(1) of this section. City's requirement that X correct the potential hazard to continue operating the hotel is not relevant in determining whether the amount paid improved the hotel. See paragraph (f)(2) of this section.

Example 12. Not a betterment; regulatory requirement. X owns a meat processing plant. X discovers that oil is seeping through the concrete walls of the plant, creating a fire hazard. Federal meat inspectors advise X that it must correct the seepage problem or shut down its plant. To correct the problem, X pays an amount to add a concrete lining to the walls from the floor to a height of about four feet and also to add concrete to the floor of the plant. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. The event necessitating the expenditure was the seepage of the oil. Prior to the seepage, the plant did not leak and was functioning for its intended use. X is not required to treat the amount paid as a betterment under paragraph (h) of this section because it does not result in a material addition or material increase in capacity, productivity, efficiency, strength or quality of the building structure or its output compared to the condition of the structure prior to the seepage of the oil. The federal meat inspectors' requirement that X correct the seepage to continue operating the plant is not relevant in determining whether the amount paid improves the plant. See paragraph (f)(2) of this section.

Example 13. Not a betterment; replacement with same part. X owns a small retail shop. A storm damages the roof of X's shop by displacing numerous wooden shingles. X pays a contractor to replace all the wooden shingles on the roof with new wooden shingles. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. The roof is part of the building structure under paragraph (e)(2)(ii)(A) of this section. The event necessitating the expenditure was the storm. Prior to the storm, the building structure was functioning for its intended use. X is not required to treat the amount paid to replace the shingles as a betterment under paragraph (h) of this section because it does not result in a material addition, or material increase in the capacity, productivity, efficiency, strength, or quality of the building structure or the output of the building structure compared to the condition of the building structure prior to the storm.

Example 14. Not a betterment; replacement with comparable part. Assume the same facts as in *Example 13,* except that wooden shingles are not available on the market. X pays a contractor to replace all the wooden shingles with comparable asphalt shingles. The amount that X pays to reshingle the roof with asphalt shingles does not result in a betterment to the shop building structure, even though the asphalt shingles may be stronger than the wooden shingles. Because the wooden shingles could not practicably be replaced with new wooden shingles, the replacement of the old shingles with comparable asphalt shingles does not, by itself, result in a betterment, and therefore, an improvement, to the shop building structure under this paragraph (h).

Example 15. Betterment; replacement with improved parts. Assume the same facts as in *Example 14,* except that, instead of replacing the wooden shingles with asphalt shingles, X pays a contractor to replace all the wooden shingles with shingles made of lightweight composite materials that are maintenance-free and do not absorb moisture. The new shingles have a 50-year warranty and a Class A fire rating. The amount paid for these shingles results in a betterment to the shop building structure under paragraphs (h)(1)(iii) and (h)(3)(iii) of this section because it results in a material increase in the quality of the shop building structure as compared to the condition of the shop building structure prior to the storm. Therefore, in accordance with paragraph (e)(2)(ii), X must treat the amount paid for the betterment of the building structure as an improvement to the building and must capitalize the amount paid under paragraph (d)(1) of this section.

Example 16. Material increase in capacity. X owns a factory building with a storage area on the second floor. X pays an amount to replace the columns and girders supporting the second floor to permit storage of supplies with a gross weight 50 percent greater than the previous load-carrying capacity of the storage area. Under paragraph (e)(2)(ii) of this section, if the amount results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. The columns and girders are part of the building structure defined under paragraph (e)(2)(ii)(A) of this section. X must treat the amount paid to replace the columns and girders as a betterment under paragraph (h)(1)(iii) of this section because it materially increases the load-carrying capacity of the building structure. The comparison rule in paragraph (h)(3)(iii) of this section does not apply to this amount because the expenditure was not necessitated by a particular event. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid for betterment of the building structure as an improvement to the building and must capitalize the amount paid under paragraph (d)(1) of this section.

Example 17. Material increase in capacity. X owns harbor facilities consisting of a slip for the loading and unloading of barges and a channel leading from the slip to the river. At the time of purchase, the channel was 150 feet wide, 1,000 feet long, and 10 feet deep. To allow for ingress and egress and for the unloading of its barges, X needs to deepen the channel to a depth of 20 feet. X pays a contractor to dredge the channel to the required depth. Assume the channel is the unit of property. X must capitalize as an improvement the amounts paid for the dredging because they result in a material increase in the capacity of the channel under paragraph (h)(1)(iii) of this section. The comparison rule in paragraph (h)(3)(iii) of this section does not apply to these amounts paid because the expenditure was not necessitated by a particular event.

Example 18. Not a material increase in capacity. Assume the same facts as in *Example 17,* except that the channel was susceptible to siltation and, by the next taxable year, the channel depth had been reduced to 18 feet. X pays a contractor to redredge the channel to a depth of 20 feet. The event necessitating the expenditure was the siltation of the channel. Both prior to the siltation and after the redredging, the depth of the channel was 20 feet. X is not required to treat the amounts paid to redredge the channel as a betterment under paragraphs (h)(1)(ii) or (h)(1)(iii) of this section because they do not result in a material addition to the unit of property or a material increase in the capacity, productivity, efficiency, strength, or quality of the unit of property or the output of the unit of property.

Example 19. Not a material increase in capacity. X owns a building used in its trade or business. The first floor has a drop-ceiling. X pays an amount to remove the drop-ceiling and repaint the original ceiling. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. The ceiling is part of the building structure as defined under paragraph (e)(2)(ii)(A) of this section. X is not required to treat the amount paid to remove the drop-ceiling as a betterment because it did not result in a material addition under paragraph (h)(1)(ii) of this section or a material increase to the capacity, productivity, efficiency, strength, or quality of the building structure or output of the building structure under paragraph (h)(1)(iii) of this section. The comparison rule in paragraph (h)(3)(iii) of this section does not apply to these amounts paid because the expenditure was not necessitated by a particular event.

(i) *Capitalization of restorations*—(1) *In general.* A taxpayer must capitalize amounts paid to restore a unit of property, including amounts paid in making good the exhaustion for which an allowance is or has been made. An amount is paid to restore a unit of property only if it—

(i) Is for the replacement of a component of a unit of property and the taxpayer has properly deducted a loss for that component (other than a casualty loss under § 1.165–7);

(ii) Is for the replacement of a component of a unit of property and the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component;

(iii) Is for the repair of damage to a unit of property for which the taxpayer has properly taken a basis adjustment as a result of a casualty loss under section 165, or relating to a casualty event described in section 165;

(iv) Returns the unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use;

(v) Results in the rebuilding of the unit of property to a like-new condition after the end of its class life as defined in paragraph (g)(4) of this section (see paragraph (i)(3) of this section); or

(vi) Is for the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of a unit of property (see paragraph (i)(4) of this section).

(2) *Restorations of buildings.* In the case of a building, an amount is paid to restore the unit of property if it restores any of the properties designated in paragraphs (e)(2)(ii), (e)(2)(iii)(B), (e)(2)(iv)(B), (e)(2)(v)(B) of this section.

(3) *Rebuild to like-new condition.* For purposes of paragraph (i)(1)(v) of this section, a unit of property is rebuilt to a like-new condition if it is brought to the status of new, rebuilt, remanufactured, or similar status under the terms of any federal regulatory guideline or the manufacturer's original specifications.

(4) *Replacement of a major component or a substantial structural part.* To determine whether an amount is for the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of the unit of property, it is appropriate to consider all the facts and circumstances. These facts and circumstances include the quantitative or qualitative significance of the part or combination of parts in relation to the unit of property. A major component or substantial structural part includes a part or combination of parts that comprise a large portion of the physical structure of the unit of property or that perform a discrete and critical function in the operation of the unit of property. However, the replacement of a minor component of the unit of property, even though such component may affect the function of the unit of property, will not generally, by itself, constitute a major component or substantial structural part.

(5) *Examples.* The following examples illustrate the application of this paragraph (i) only and do not address whether capitalization is required under another provision of this section or another provision of the Internal Revenue Code (for example, section 263A). Unless otherwise stated, assume that X has not properly deducted a loss for, nor taken into account the adjusted basis on a sale or exchange of, any unit of property, asset, or component of a unit of property that is replaced:

Example 1. Replacement of loss component. X owns a manufacturing building containing various types of manufacturing equipment. X does a cost segregation study of the manufacturing building and properly determines that a walk-in freezer in the manufacturing building is section 1245 property as defined in section 1245(a)(3). The freezer is not part of the building structure under paragraph (e)(2)(i) of this section or the HVAC system, which is a separate building system under paragraph (e)(2)(ii)(B)(*1*) of this section. Several components of the walk-in freezer cease to function and X decides to replace them. X abandons the old freezer components and properly recognizes a loss from the abandonment of the components. X replaces the abandoned freezer components with new components and incurs costs to acquire and install the new components. Under paragraph (i)(1)(i) of this section, X must capitalize the amounts paid to acquire and install the new freezer components because X replaced components for which it had properly deducted a loss.

Example 2. Replacement of sold component. Assume the same facts as in *Example 1* except that X did not abandon the components, but instead sold them to another party and properly recognized a loss on the sale. Under paragraph (i)(1)(ii) of this section, X must capitalize the amounts paid to acquire and install the new freezer components because X replaced components for which it had properly taken into account the adjusted basis of the components in realizing a loss from the sale of the components.

Example 3. Restoration after casualty loss. X owns an office building that it uses in its trade or business. A storm damages the office building at a time when the building has an adjusted basis of $500,000. X deducts under section 165 a casualty loss in the amount of $50,000 and properly reduces its basis in the office building to $450,000. X hires a contractor to repair the damage to the building and pays the contractor $50,000 for the work. Under paragraph (i)(1)(iii) of this section, X must capitalize the $50,000 amount paid to the contractor because X properly adjusted its basis in that amount as a result of a casualty loss under section 165.

Example 4. Restoration after casualty event. Assume the same facts as in *Example 3,* except that X receives insurance proceeds of $50,000 after the casualty to compensate for its loss. X cannot deduct a casualty loss under section 165 because its loss was compensated by insurance. However, X properly reduces its basis in the property by the amount of the insurance proceeds. Under paragraph (i)(1)(iii) of this section, X must capitalize the $50,000 amount paid to the contractor because X has properly taken a basis adjustment relating to a casualty event described in section 165.

Example 5. Restoration of property in a state of disrepair. X owns and operates a farm with several barns and outbuildings. X did not use or maintain one of the outbuildings on a regular basis, and the outbuilding fell into a state of disrepair. The outbuilding previously was used for storage but can no longer be used for that purpose because the building is not structurally sound. X decides to restore the outbuilding and pays an amount to shore up the walls and replace the siding. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The walls and siding are part of the building structure under paragraph (e)(2)(ii)(A) of this section. Under paragraph (i)(1)(iv) of this section, X must treat the amount paid to shore up the walls and replace the siding as a restoration of the building structure because the amounts return the building structure to its ordinarily efficient operating condition after it had deteriorated to a state of disrepair and was no longer functional for its intended use. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid as an improvement to the building and must capitalize the amount paid under paragraph (d)(2) of this section.

Example 6. Rebuild of property to like-new condition before end of class life. X is a Class I railroad that owns a fleet of freight cars. Freight cars have a recovery period of 7 years under section 168(c) and a class life of 14 years. Every 8 to 10 years, X rebuilds its freight cars. Ten years after X places the freight car in service, X performs a rebuild, which includes a complete disassembly, inspection, and reconditioning or replacement of components of the suspension and draft systems, trailer hitches, and other special equipment. X modifies the car to upgrade various components to the latest engineering standards. The freight car essentially is stripped to the frame, with all of its substantial components either reconditioned or replaced. The frame itself is the longest-lasting part of the car and is reconditioned. The walls of the freight car are replaced or are sandblasted and repainted. New wheels are installed on the car. All the remaining components of the car are restored before they are reassembled. At the end of the rebuild, the freight car has been restored to rebuilt condition under the manufacturer's specifications. Assume the freight car is the unit of property. X is not required to capitalize under paragraph (i)(1)(v) of this section the amounts paid to rebuild the freight car because, although the amounts paid restore the freight car to like-new condition, the amounts were not paid after the end of the class life of the freight car.

Example 7. Rebuild of property to like-new condition after end of class life. Assume the same facts as in *Example 6,* except that X rebuilds the freight car 15 years after X places it in service. Under paragraph (i)(1)(v) of this section, X must capitalize the amounts paid to rebuild the freight car because the amounts paid restore the freight car to like-new condition after the end of the class life of the freight car.

Example 8. Replacement of major component or substantial structural part; personal property. X is a common carrier that owns a fleet of petroleum hauling trucks. X pays amounts to replace the existing engine, cab, and petroleum tank with a new engine, cab, and tank. Assume the tractor of the truck (which includes the cab and the engine) is a single unit of property, and that the trailer (which contains the petroleum tank) is a separate unit of property. The new engine and cab constitute parts or combinations of parts that comprise a major component or substantial structural part of X's tractor. Therefore, the amounts paid for the replacement of those components must be capitalized under paragraph (i)(1)(vi) of this section. The new petroleum tank constitutes a part or combination of parts that comprise a major component and a substantial structural part of the trailer. Accordingly, the amounts paid for the replacement of the tank also must be capitalized under paragraph (i)(1)(vi) of this section.

Example 9. Repair performed during a restoration. Assume the same facts as in *Example 8,* except that, at the same time the engine and cab of the tractor are replaced, X pays amounts to paint the cab of the tractor with its company logo and to fix a broken taillight on the tractor. The repair of the broken taillight and the painting of the cab generally are deductible expenses under § 1.162–4T. However, under paragraph (f)(3)(i) of this section, a taxpayer must capitalize all the direct costs of an improvement and all the indirect costs that directly benefit or are incurred by reason of an improvement in accordance with the rules under section 263A. Repairs and maintenance that do not directly benefit or are not incurred by reason of an improvement are not required to be capitalized under section 263(a), regardless of whether they are made at the same time as an improvement. Under paragraph (f)(3)(i) of this section, X must capitalize the amounts paid to paint the cab as part of the improvement to the tractor because these amounts directly benefit and are incurred by reason of the restoration of the cab. Amounts paid to repair the broken taillight, however, are not incurred by reason of the restoration of the tractor, nor do the amounts paid directly benefit the tractor restoration, even though the repair was performed at the same time as the restoration. Thus, X must capitalize the amounts paid to paint the cab under paragraph (i)(1)(vi) and (f)(3)(i) of this section, but X is not required to capitalize the amounts paid to repair the broken taillight.

Example 10. Related amounts to replace major component or substantial structural part; personal property. (i) X owns a retail gasoline station, consisting of a paved area used for automobile access to the pumps and parking areas, a building used to market gasoline, and a canopy covering the gasoline pumps. The premises also consist of underground storage tanks (USTs) that are connected by piping to the pumps and are part of the machinery used in the immediate retail sale of gas. To comply with regulations issued by the Environmental Protection Agency, X is required to remove and replace leaking USTs. In Year 1, X hires a contractor to perform the removal and replacement, which consists of removing the old tanks and installing new tanks with leak detection systems. The removal of the old tanks includes removing the paving material covering the tanks, excavating a hole large enough to gain access to the old tanks, disconnecting any strapping and pipe connections to the old tanks, and lifting the old tanks out of the hole. Installation of the new tanks includes placement of a liner in the excavated hole, placement of the new tanks, installation of a leak detection system, installation of an overfill system, connection of the tanks to the pipes leading to the pumps, backfilling of the hole, and replacement of the paving. X also is required to pay a permit fee to the county to undertake the installation of the new tanks.

(ii) X pays the permit fee to the county on October 15, Year 1. On December 15, Year 1, the contractor completes the removal of the old USTs and bills X for the costs of removal. On January 15, Year 2, the contractor completes the installation of the new USTs and bills X for the remainder of the work. Assume that X computes its taxes on a calendar year basis and X's gasoline distribution system is the unit of property. Under paragraph (i)(1)(vi) of this section, X must capitalize the amounts paid to replace the USTs as a restoration to the gasoline distribution system because the USTs are parts or combinations of parts that comprise a major component and substantial structural part of the gasoline distribution system. Moreover, under paragraph (f)(3) of this section, X must capitalize the costs of removing the old USTs because these amounts directly benefit and are incurred by reason of the improvement to the gasoline distribution system. Finally, under paragraph (f)(4) of this section, X must capitalize the aggregate of related amounts paid to improve the gasoline distribution system, including the amount paid to the county, the amount paid to remove the old USTs, and the amount paid to install the new USTs, even though the amounts were separately invoiced, paid to different parties, and incurred in different tax years.

Example 11. Not replacement of major component or substantial structural part; personal property. X owns a machine shop in which it makes dies used by manufacturers. In Year 1, X purchased a drill press for use in its production process. In Year 3, X discovers that the power switch assembly, which controls the supply of electric power to the drill press, has become damaged and could not operate. To correct this problem, X paid amounts to replace the power switch assembly with comparable, commercially available and reasonable replacement parts. Assume that the drill press is a unit of property under paragraph (e) of this section and the power switch assembly is a small component of the drill press that may be removed and installed with relative ease. Thus, the power switch assembly is not a major component or substantial structural part of X's drill press under paragraph (i)(3) of this section. X is not required to capitalize the costs to replace the power switch assembly under paragraph (i)(1)(vi) of this section because the replacement, by itself, does not constitute the replacement of a part or a combination of parts that comprise a major component or substantial structural part of X's drill press. But see section 263A and the regulations thereunder for the requirement to capitalize indirect costs that directly benefit or are incurred by reason of production activities.

Example 12. Replacement of major component or substantial structural part; roof. X owns a large retail store. X discovers a leak in the roof of the store and hires a contractor to inspect and fix the roof. The contractor discovers that a major portion of the sheathing and rafters has rotted, and recommends the replacement of the entire roof. X pays the contractor to replace the entire roof with a new roof. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The roof is part of the building structure under paragraph (e)(2)(ii)(A) of this section and comprises a major component or substantial structural part of X's building structure under paragraph (i)(4) of this section. Under paragraph (i)(1)(vi) of this section, X must treat the amount paid to replace the roof as a restoration because X paid the amount to replace a major component or substantial structural part of X's building structure. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid to restore the building structure as an improvement to the building and must capitalize the amount paid under paragraph (d)(2) of this section.

Example 13. Replacement of major component or substantial structural part; roof. Assume the same facts as *Example 12* except the contractor recommends replacement of a significant portion of the roof, but not the entire roof. Accordingly, X pays an amount to replace a large portion of the decking, insulation, and membrane of the roof of X's retail building. The portion of the roof replaced comprises a major component or substantial structural part of the building structure under paragraph (i)(4) of this section. Thus, under paragraph (i)(1)(vi) of this section, X must treat the amount paid for the roof work as a restoration of the building structure because X paid the amount to replace a major component or substantial structural part of the building structure. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid as an improvement to the building and must capitalize the amount paid under paragraph (d)(2) of this section.

Example 14. Not replacement of major component or substantial structural part; roof membrane. X is in the business of manufacturing parts. X owns a factory facility in which the parts are manufactured. The roof over X's facility is comprised of structural elements, insulation, and a waterproof membrane. Over time, the waterproof membrane began to wear and leakage began to occur. Consequently, X pays an amount to replace the plant's worn roof membrane with a similar but new membrane. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The roof, including the membrane, is part of the building structure as defined under paragraph (e)(2)(ii)(A) of this section. Although the roof membrane may affect the function of the building structure, it is not, by itself, a major component or substantial structural part of X's building structure under paragraph (i)(4) of this section. Because the roof membrane is not a major component or substantial structural part of the building structure, X is not required to treat the amount paid to replace the roof membrane as a restoration of the building structure under paragraph (i)(1)(vi) of this section. But see section 263A and the regulations thereunder for the requirement to capitalize indirect costs that directly benefit or are incurred by reason of production activities.

Example 15. Replacement of major component or substantial structural part; HVAC system. X owns a building in which it operates an office that provides medical services. The building contains one HVAC system, which is comprised of a furnace, an air conditioning unit, and duct work that runs throughout the building to distribute the heat or air conditioning throughout the building. The furnace in X's building breaks down and X pays an amount to replace it with a new furnace. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The heating and air conditioning system, including the furnace, is a building system under paragraph (e)(2)(ii)(B)(*1*) of this section. The furnace performs a discrete and critical function in the operation of the HVAC system, and is therefore a major component or substantial structural part of the building system under paragraph (i)(4) of this section. Because the furnace comprises a major component or substantial structural part of a building system, X must treat the amount paid to replace the furnace as a restoration of the building system under paragraph (i)(1)(vi) of this section. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid as an improvement to the building and must capitalize the amount paid under paragraph (d)(2) of this section.

Example 16. Replacement of major component or substantial structural part; HVAC system. X owns a large office building in which it provides consulting services. The building contains one HVAC system, which is comprised of one chiller unit, one boiler, pumps, duct work, diffusers, air handlers, outside air intake and a cooling tower. The chiller unit includes the compressor, evaporator, condenser, and expansion valve, and functions to cool the water used to generate air conditioning throughout the building. X pays an amount to replace the chiller with a more energy efficient unit. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The HVAC system, including the chiller unit, is a building system under paragraph (e)(2)(ii)(B)(*1*) of this section. The chiller unit performs a discrete and critical function in the operation of the HVAC system and is therefore a major component or substantial structural part of the HVAC system under paragraph (i)(4) of this section. Because the chiller unit comprises a major component or substantial structural part of a building system, X must treat the amount paid to replace the chiller unit as a restoration to a building system under paragraph (i)(1)(vi) of this section. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid as an improvement to the building and must capitalize the amount paid under paragraph (d)(2) of this section.

Example 17. Not replacement of major component or substantial structural part; HVAC system. X owns an office building that it uses to provide services to customers. The building contains an HVAC system that incorporates ten roof-mounted units that provide heating and air conditioning for different parts of the building. The HVAC system also consists of controls for the entire system and duct work that distributes the heated or cooled air to the various spaces in the building's interior. X begins to experience climate control problems in various offices throughout the office building and consults with a contractor to determine the cause. The contractor recommends that X replace two of the roof-mounted units. X pays an amount to replace the two specified units. No work is performed on the other roof-mounted heating/cooling units, the duct work, or the controls. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The HVAC system, including the two-roof mounted units, is a building system under paragraph (e)(2)(ii)(B)(*1*) of this section. The two roof-mounted heating/cooling units, by themselves, do not comprise a large portion of the physical structure of the HVAC system or perform a discrete and critical function in the operation of the system. Therefore, under paragraph (i)(4) of this section, the two units do not constitute a major component or substantial structural part of the building system. Accordingly, X is not required to treat the amount paid to replace the two roof-mounted heating/cooling units as a restoration of a building system under paragraph (i)(1)(iv) of this section.

Example 18. Replacement of major component or substantial structural part; fire protection system. X owns a building that it uses to operate its business. X pays an amount to replace the sprinkler system in the building with a new sprinkler system. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The fire protection and alarm system, including the sprinkler system, is a building system under paragraph (e)(2)(ii)(B)(*6*) of this section. The sprinkler system performs a discrete and critical function in the operation of the fire protection and alarm system and is therefore a major component or substantial structural part of the fire protection and alarm system under paragraph (i)(4) of this section. Because the sprinkler system comprises a major component or substantial structural part of a building system, X must treat the amount paid to replace the sprinkler system as a restoration to a building system under paragraph (i)(1)(vi) of this section. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid as an improvement to the building and must capitalize the amount paid under paragraph (d)(2) of this section.

Example 19. Replacement of major component or substantial structural part; electrical system. X owns a building that it uses to operate its business. X pays an amount to replace the wiring throughout the building with new wiring that meets building code requirements. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The electrical system, including the wiring, is a building system under paragraph (e)(2)(ii)(B)(*3*) of this section. The wiring performs a discrete and critical function in the operation of the electrical system and is therefore a major component or substantial structural part of the electrical system under paragraph (i)(4) of this section. Because the wiring comprises a major component or substantial structural part of a building system, X must treat the amount paid to replace the wiring as a restoration to a building system under paragraph (i)(1)(vi) of this section. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid as an improvement to the building and must capitalize the amount paid under paragraph (d)(2) of this section.

Example 20. Replacement of major component or substantial structural part; plumbing system. X owns a building in which it conducts a retail business. The retail building has three floors. The retail building has men's and women's restrooms on two of the three floors. X decides to update the restrooms by paying an amount to replace the plumbing fixtures in all of the restrooms, including the toilets, sinks, and associated fixtures, with modern style plumbing fixtures of similar quality and function. X does not replace the pipes connecting the fixtures to the building's plumbing system. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The plumbing system, including the plumbing fixtures, is a building system under paragraph (e)(2)(ii)(B)(*2*) of this section. The plumbing fixtures in all the restrooms perform a discrete and critical function in the operation of the plumbing system and comprise a large portion of the physical structure of plumbing system. Therefore, under paragraph (i)(4) of this section, the plumbing fixtures comprise a major component or substantial structural part of the plumbing system, and X must treat the amount paid to replace all of the plumbing fixtures as a restoration of a building system under paragraph (i)(1)(vi) of this section. As a result, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid to restore the plumbing system as an improvement to the building and must capitalize these amounts under paragraph (d)(2) of this section.

Example 21. Not replacement of major component or substantial structural part; plumbing system. Assume the same facts as *Example 20* except that X does not update all the bathroom fixtures. Instead, X only pays an amount to replace three of the twenty sinks located in the various restrooms because these sinks had cracked. The three replaced sinks, by themselves, do not comprise a large portion of the physical structure of the plumbing system nor do they perform a discrete and critical function in the operation of the plumbing system. Therefore, under paragraph (i)(4) of this section, the sinks do not constitute a major component or substantial structural part of the building system. Accordingly, X is not required to treat the amount paid to replace the sinks as a restoration of a building system under paragraph (i)(1)(iv) of this section.

Example 22. Replacement of major component or substantial structural part; remodel. (i) X owns and operates a hotel building. X decides that to attract customers and to remain competitive, it needs to update the guest rooms in its facility. Accordingly, X pays amounts to replace the bathtubs, toilets, sinks, plumbing fixtures, and to repair, repaint, and retile the bathroom walls and floors, which was necessitated by the installation of the new plumbing components. The replacement bathtubs, toilets, sinks, plumbing fixtures, and tile are new and in a different style, but are similar in function and quality to the replaced items. X also pays amounts to replace certain section 1245 property, such as the guest room furniture, carpeting, drapes, table lamps, and partition-walls separating the bathroom area. X completes this work on two floors at a time, closing those floors and leaving the rest of the hotel open for business. In Year 1, X pays amounts to perform the updates for eight of the twenty hotel room floors, and expects to complete the renovation of the remaining rooms over the next 2 years.

(ii) Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The plumbing system, including the bathtubs, toilets, sinks, and plumbing fixtures, is a building system under paragraph (e)(2)(ii)(B)(*2*) of this section. All the bathtubs, toilets, sinks, and plumbing fixtures in the hotel building perform a discrete and critical function in the operation of the plumbing system and comprise a large portion of the physical structure of plumbing system. Therefore, under paragraph (i)(4) of this section, these plumbing components comprise major components or substantial structural parts of the plumbing system, and X must treat the amount paid to replace these plumbing components as a restoration of a building system under paragraph (i)(1)(vi) of this section. In addition, under paragraph (f)(3)(i) of this section, X must treat the costs of repairing, repainting, and retiling the bathroom walls and floors as improvement costs because these costs directly benefit and are incurred by reason of the improvement to the plumbing system. Further, under paragraph (f)(4) of this section, X must treat the costs incurred in Years 1, 2, and 3 for the bathroom remodeling as improvement costs, even though they are incurred over a period of several taxable years, because they are part of the aggregate of related amounts paid to improve the plumbing system. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amounts it paid to improve the plumbing system as the costs of improving the building and must capitalize the amounts under paragraph (d)(2) of this section. In addition, X must capitalize the amounts paid to acquire and install each section 1245 property under § 1.263(a)–2T of the regulations.

Example 23. Not replacement of major component or substantial structural part; windows. X owns a large office building that it uses to provide office space for employees that manage X's operations. The building has 300 exterior windows. In Year 1, X pays an amount to replace 30 of the exterior windows that had become damaged. At the time of these replacements, X has no plans to replace any other windows in the near future. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The exterior windows are part of the building structure as defined under paragraph (e)(2)(ii)(A) of this section. The 30 replacement windows do not comprise a large portion of the physical structure of the office building structure and, by themselves, do not perform a discrete and critical function in the operation of X's building structure. Therefore, under paragraph (i)(4) of this section, the replacement windows do not constitute major components or substantial structural parts of the building structure. Accordingly, X is not required to treat the amount paid to replace the windows a restoration of a building system under paragraph (i)(1)(iv) of this section.

Example 24. Replacement of major component or substantial structural part; windows. Assume the same facts as *Example 23* except that X replaces 200 of the 300 windows on the building. In addition, as a result of damage caused during the window replacements, X also pays an amount to repaint the interior trims associated with the replaced windows. The 200 replacement windows comprise a large portion of the physical structure of X's building and perform a discrete and critical function in the operation of the building structure. Therefore, under paragraph (i)(4) of this section, the 200 windows comprise a major component or substantial structural part of the building structure, and X must treat the amount paid to replace the windows as a restoration of the building structure under paragraph (i)(1)(vi) of this section. As a result, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amounts paid to restore the building structure as an improvement to the building and must capitalize the amounts under paragraph (d)(2) of this section.

Example 25. Not replacement of major component or substantial structural part; floors. X owns and operates a hotel building. X decides to refresh the appearance of the hotel lobby by replacing the floors in the lobby. The hotel lobby comprises a small portion of the entire hotel building. X pays an amount to replace the wood flooring in the lobby with new wood flooring. X did not replace any other flooring in the building. Assume that the wood flooring constitutes section 1250 property. Under paragraph (e)(2)(ii) of this section, if the amount paid results in a restoration of the building structure or any building system, X must treat the amount as an improvement to the building. The wood flooring is part of the building structure under paragraph (e)(2)(ii)(A) of this section. The replacement wood flooring in the lobby of the building does not comprise a large portion of the physical structure of the hotel building or perform a discrete and critical function in the operation of the hotel building structure. Therefore, under paragraph (i)(4) of this section, the wood flooring does not a constitute major component or substantial structural part of the hotel building structure. Accordingly, X is not required to treat the amount paid to replace the wood flooring in the hotel lobby as a restoration under paragraph (i)(1)(vi) of this section.

Example 26. Replacement of major component or substantial structural part; floors. Assume the same facts as *Example 25* except that X decides to refresh the appearance of all the public areas of the hotel building by replacing the floors. To that end, X pays an amount to replace all the wood floors in all the public areas of the hotel building with new wood floors. The public areas include the lobby, the hallways, the meeting rooms, and other public rooms throughout the hotel interiors. The replacement wood floors in all the public areas comprise a large portion of the physical structure of the hotel building structure and perform a discrete and critical function in the operation of X's hotel building structure. Therefore, under paragraph (i)(4) of this section, replacement wood floors comprise a major component or substantial structural part of the building structure, and X must treat the amount paid to replace the floors as a restoration of the building structure under paragraph (i)(1)(vi) of this section. As a result, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amounts paid to restore the building structure as an improvement to the building and must capitalize the amounts under paragraph (d)(2) of this section.

(j) *Capitalization of amounts to adapt property to a new or different use*—(1) *In general.* Taxpayers must capitalize amounts paid to adapt a unit of property to a new or different use. In general, an amount is paid to adapt a unit of property to a new or different use if the adaptation is not consistent with the taxpayer's intended ordinary use of the unit of property at the time originally placed in service by the taxpayer.

(2) *Adapting buildings to new or different use.* In the case of a building, an amount is paid to adapt the unit of property to a new or different use if it adapts to a new or different use any of the properties designated in paragraphs (e)(2)(ii), (e)(2)(iii)(B), (e)(2)(iv)(B), or (e)(2)(v)(B) of this section.

(3) *Examples.* The following examples illustrate solely the rules of this paragraph (j). Even if capitalization is not required in an example under this paragraph (j), the amounts paid in the example may be subject to capitalization under a different provision of this section or another provision of the Internal Revenue Code (for example, section 263A). Unless otherwise stated, assume that X has not properly deducted a loss for any unit of property, asset, or component of a unit of property that is removed and replaced.

Example 1. New or different use. X is a manufacturer and owns a manufacturing building that it has used for manufacturing since Year 1, when X placed it in service. In Year 30, X pays an amount to convert its manufacturing building into a showroom for its business. To convert the facility, X removes and replaces various structural components to provide a better layout for the showroom and its offices. X also repaints the building interiors as part of the conversion. None of the materials used are better than existing materials in the building. Under paragraph (e)(2)(ii) of this section, if the amount paid adapts the building structure to a new or different use, X must treat the amount as an improvement to the building. Under paragraph (j)(1) of this section, the amount paid to convert the manufacturing facility into a showroom adapts the building structure to a new or different use because the conversion is not consistent with X's intended ordinary use of the building structure at the time it was placed in service. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the amount paid for the adaptation of the building structure as an amount that improves the building. Accordingly, X must capitalize the amount as an improvement under paragraph (d)(3) of this section.

Example 2. Not a new or different use. X owns a building consisting of twenty retail spaces. The space was designed to be reconfigured; that is, adjoining spaces could be combined into one space. One of the tenants expands its occupancy to include two adjoining retail spaces. To facilitate the new lease, X pays an amount to remove the walls between the three retail spaces. Assume that the walls between spaces are part of the building and its structural components. Under paragraph (e)(2)(ii) of this section, if the amount paid adapts the buildings structure to a new or different use, X must treat the amount as an improvement to the building. Under paragraph (j)(1) of this section, the amount paid to convert three retail spaces into one larger space for an existing tenant does not adapt X's building structure to a new or different use because the combination of retail spaces is consistent with X's intended, ordinary use of the building structure. Therefore, the amount paid by X to remove the walls does not improve the building under paragraph (d)(3) of this section.

Example 3. Not a new or different use. X owns a building consisting of twenty retail spaces. X decides to sell the building. In anticipation of selling the building, X pays an amount to repaint the interior walls and to refinish the hardwood floors. Under paragraph (e)(2)(ii) of this section, if the amount paid adapts the buildings structure to a new or different use, X must treat the amount as an improvement to the building. Preparing the building for sale does not constitute a new or different use for the building structure under paragraph (j)(1) of this section. Therefore, the amount paid to prepare the building structure for sale does not improve the building under paragraphs (d)(3) of this section.

Example 4. New or different use. X owns a parcel of land on which it previously operated a manufacturing facility. Assume that the land is the unit of property. During the course of X's operation of the manufacturing facility, the land became contaminated with wastes from its manufacturing processes. X discontinues manufacturing operations at the site, and decides to sell the property to a developer that intends to use the property for residential housing. In anticipation of selling the land, X pays an amount to cleanup the land to a standard that is required for the land to be used for residential purposes. In addition, X pays an amount to regrade the land so that it can be used for residential purposes. Amounts that X pays to cleanup wastes that were discharged in the course of X's manufacturing operations do not adapt the land to a new or different use, regardless of the extent to which the land was cleaned. Therefore, X is not required to capitalize the amount paid for the cleanup under paragraph (j)(1) of this section. However, the amount paid to regrade the land so that it can be used for residential purposes adapts the land to a new or different use that is inconsistent with X's intended ordinary use of the property at the time it was placed in service. Accordingly, the amounts paid to regrade the land must be capitalized as improvements under paragraphs (j)(1) of this section.

(k) *Optional regulatory accounting method*—(1) *In general.* This paragraph (k) provides an optional simplified method (the regulatory accounting method) for regulated taxpayers to determine whether amounts paid to repair, maintain, or improve tangible property are to be treated as deductible expenses or capital expenditures. A taxpayer that uses the regulatory accounting method described in paragraph (k)(3) of this section must use that method for property subject to regulatory accounting instead of determining whether amounts paid to repair, maintain, or improve property are capital expenditures or deductible expenses under the general principles of sections 162(a), 212, and 263(a). Thus, the capitalization rules in paragraph (d) (and the routine maintenance safe harbor described in paragraph (g)) of this section do not apply to amounts paid to repair, maintain, or improve property subject to regulatory accounting by taxpayers that use the regulatory accounting method under this paragraph (k). However, section 263A continues to apply to costs required to be capitalized to property produced by the taxpayer or to property acquired for resale.

(2) *Eligibility for regulatory accounting method.* A taxpayer that is engaged in a trade or business in a regulated industry may use the regulatory accounting method under this paragraph (k). For purposes of this paragraph (k), a taxpayer in a regulated industry is a taxpayer that is subject to the regulatory accounting rules of the Federal Energy Regulatory Commission (FERC), the Federal Communications Commission (FCC), or the Surface Transportation Board (STB).

(3) *Description of regulatory accounting method.* Under the regulatory accounting method, a taxpayer must follow its method of accounting for regulatory accounting purposes in determining whether an amount paid improves property under this section. Therefore, a taxpayer must capitalize for Federal income tax purposes an amount paid that is capitalized as an improvement for regulatory accounting purposes. A taxpayer must not capitalize for Federal income tax purposes under this section an amount paid that is not capitalized as an improvement for regulatory accounting purposes. A taxpayer that uses the regulatory accounting method must use that method for all of its tangible property that is subject to regulatory accounting rules. The method does not apply to tangible property that is not subject to regulatory accounting rules. The method also does not apply to property for the taxable years in which the taxpayer elected to apply the repair allowance under § 1.167(a)–11(d)(2).

(4) *Examples.* The rules of this paragraph (k) are illustrated by the following examples:

Example 1. Taxpayer subject to regulatory accounting rules of FERC. X is an electric utility company that operates a power plant that generates electricity and that owns and operates network assets to transmit and distribute the electricity to its customers. X is subject to the regulatory accounting rules of FERC and X chooses to use the regulatory accounting method under paragraph (k) of this section. X does not capitalize on its books and records for regulatory accounting purposes the cost of repairs and maintenance performed on its turbines or its network assets. Under the regulatory accounting method, X must not capitalize for Federal income tax purposes amounts paid for repairs performed on its turbines or its network assets.

Example 2. Taxpayer not subject to regulatory accounting rules of FERC. X is an electric utility company that operates a power plant to generate electricity. X previously was subject to the regulatory accounting rules of FERC but, for various reasons, X is no longer required to use FERC's regulatory accounting rules. X cannot use the regulatory accounting method provided in this paragraph (k).

Example 3. Taxpayer subject to regulatory accounting rules of FCC. X is a telecommunications company that is subject to the regulatory accounting rules of the FCC. X chooses to use the regulatory accounting method under this paragraph (k). X's assets include a telephone central office switching center, which contains numerous switches and various switching equipment. X capitalizes on its books and records for regulatory accounting purposes the cost of replacing each switch. Under the regulatory accounting method, X is required to capitalize for Federal income tax purposes amounts paid to replace each switch.

Example 4. Taxpayer subject to regulatory accounting rules of STB. X is a Class I railroad that is subject to the regulatory accounting rules of the STB. X chooses to use the regulatory accounting method under this paragraph (k). X capitalizes on its books and records for regulatory accounting purposes the cost of locomotive rebuilds. Under the regulatory accounting method, X is required to capitalize for federal income tax purposes amounts paid to rebuild its locomotives.

(l) *Methods of accounting authorized in published guidance.* A taxpayer may use a repair allowance method of accounting or any other method of accounting that is authorized in published guidance in the **Federal Register** or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter).

(m) *Treatment of capital expenditures.* Amounts required to be capitalized under this section are capital expenditures and must be taken into account through a charge to capital account or basis, or in the case of property that is inventory in the hands of a taxpayer, through inclusion in inventory costs. See section 263A for the treatment of direct and indirect costs of producing property or acquiring property for resale.

(n) *Recovery of capitalized amounts.* Amounts that are capitalized under this section are recovered through depreciation, cost of goods sold, or by an adjustment to basis at the time the property is placed in service, sold, used, or otherwise disposed of by the taxpayer. Cost recovery is determined by the applicable Internal Revenue Code and regulation provisions relating to the use, sale, or disposition of property.

(o) *Accounting method changes.* Except as otherwise provided in this section, a change to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481, and the regulations thereunder apply. A taxpayer seeking to change to a method of accounting permitted in this section must secure the consent of the Commissioner in accordance with § 1.446–1(e) and follow the administrative procedures issued under § 1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to change its accounting method.

(p) *Effective/applicability date.* This section applies to taxable years beginning on or after January 1, 2012. For the applicability of regulations to taxable years beginning before January 1, 2012, see § 1.263(a)–3 in effect prior to January 1, 2012 (§ 1.263(a)–3 as contained in 26 CFR part 1 edition revised as of April 1, 2011).

(q) *Expiration date.* The applicability of this section expires on of before December 23, 2014.

■ **Par. 31.** Section 1.263(a)–6T is added to read as follows:

§ 1.263(a)–6T Election to deduct or capitalize certain expenditures (temporary).

(a) *In general.* Under certain provisions of the Internal Revenue Code, taxpayers may elect to treat capital expenditures as deductible expenses or as deferred expenses, or to treat deductible expenses as capital expenditures.

(b) *Election provisions.* The sections referred to in paragraph (a) of this section include:

(1) Section 173 (circulation expenditures);

(2) Section 174 (research and experimental expenditures);

(3) Section 175 (soil and water conservation expenditures; endangered species recovery expenditures);

(4) Section 179 (election to expenses certain depreciable business assets);

(5) Section 179A (deduction for clean-fuel vehicles and certain refueling property);

(6) Section 179B (deduction for capital costs incurred in complying with environmental protection agency sulfur regulations);

(7) Section 179C (election to expense certain refineries);

(8) Section 179D (energy efficient commercial buildings deduction);

(9) Section 179E (election to expense advanced mine safety equipment);

(10) Section 180 (expenditures by farmers for fertilizer);

(11) Section 181 (treatment of certain qualified film and television productions);

(12) Section 190 (expenditures to remove architectural and transportation

barriers to the handicapped and elderly);

(13) Section 191 (tertiary injectants);

(14) Section 194 (treatment of reforestation expenditures);

(15) Section 195 (start-up expenditures);

(16) Section 198 (expensing of environmental remediation costs);

(17) Section 198A (expensing of qualified disaster expenses);

(18) Section 248 (organization expenditures of a corporation);

(19) Section 266 (carrying charges);

(20) Section 616 (development expenditures); and

(21) Section 709 (organization and syndication fees of a partnership).

(c) *Effective/applicability date.* This section applies to taxable years beginning on or after January 1, 2012. For the applicability of regulations to taxable years beginning before January 1, 2012, see § 1.263(a)–3 in effect prior to January 1, 2012 (§ 1.263(a)–3 as contained in 26 CFR part 1 edition revised as of April 1, 2011). For the effective dates of the enumerated election provisions, see those Internal Revenue Code sections and the regulations thereunder.

(d) *Expiration date.* The applicability of this section expires on of before December 23, 2014.

■ **Par. 32.** Section 1.263A–1 is amended by:

■ 1. Adding paragraph (b)(14).
■ 2. Revising paragraph (c)(4).
■ 3. Revising paragraph (e)(2)(i)(A).
■ 4. Revising paragraph (e)(3)(ii)(E).
■ 5. Revising paragraph (l).
■ 6. Adding paragraph (m).

The additions and revisions read as follows:

§ 1.263A–1 Uniform capitalization of costs.

* * * * *

(b) * * *

(14) [Reserved]. For further guidance, see § 1.263A–1T(b)(14).

(c) * * *

(4) [Reserved]. For further guidance, see § 1.263A–1T(c)(4).

* * * * *

(e) * * *

(2) * * *

(i) * * *

(A) [Reserved]. For further guidance, see § 1.263A–1T(e)(2)(i)(A).

* * * * *

(3) * * *

(ii) * * *

(E) [Reserved]. For further guidance, see § 1.263A–1T(e)(3)(ii)(E).

* * * * *

(l) [Reserved]. For further guidance, see § 1.263A–1T(l).

(m) [Reserved]. For further guidance, see § 1.263A–1T(m).

■ **Par. 33.** Section 1.263A–1T is added to read as follows:

§ 1.263A–1T Uniform capitalization of costs (temporary).

(a) through (b)(13) [Reserved]. For further guidance, see § 1.263A–1(a) through (b)(13).

(14) *Property subject to de minimis rule.* Section 263A does not apply to the costs of property produced by a taxpayer to which the taxpayer properly applies the de minimis rule under § 1.263(a)–2T(g). However, the cost of property to which a taxpayer properly applies the de minimis rule under § 1.263(a)–2T(g) may be required to be capitalized to other property as a cost incurred by reason of the production of the other property that is subject to section 263A.

(c)(1) through (c)(3) [Reserved]. For further guidance, see § 1.263A–1(c)(1) through (c)(3).

(4) *Recovery of capitalized costs.* Except as provided in § 1.162–3T(a)(2) (amounts paid to produce incidental materials and supplies), costs that are capitalized under section 263A are recovered through depreciation, amortization, cost of goods sold, or by an adjustment to basis at the time the property is used, sold, placed in service, or otherwise disposed of by the taxpayer. Cost recovery is determined by the applicable Internal Revenue Code and regulation provisions relating to use, sale, or disposition of property.

(d)(1) through (e)(2)(i) [Reserved]. For further guidance, see § 1.263A–1(d)(1) through (e)(2)(i).

(A) *Direct material costs. Direct materials costs* include the cost of those materials that become an integral part of specific property produced and those materials that are consumed in the ordinary course of production and that can be identified or associated with particular units or groups of units of property produced. For example, a cost described in § 1.162–3T, relating to the cost of a material or supply, may be a direct material cost.

(e)(2)(i)(B) through (e)(2)(ii)(D) [Reserved]. For further guidance, see § 1.263A–1(e)(2)(i)(B) through (e)(2)(ii)(D).

(E) *Indirect material costs.* Indirect material costs include the cost of materials that are not an integral part of specific property produced and the cost of materials that are consumed in the ordinary course of performing production or resale activities that cannot be identified or associated with particular units of property. Thus, for example, a cost described in § 1.162–3T, relating to the cost of a material or supply, may be an indirect cost.

(e)(2)(ii)(F) through (k)(5) [Reserved]. For further guidance, see § 1.263A–1(e)(2)(ii)(F) through (k)(5).

(l) *Change in method of accounting for de minimis costs.* A change in the treatment of amounts paid for property subject to the de minimis rule to comply with paragraph (b)(14) of this section is a change in method of accounting to which the provisions of sections 446 and 481, and the regulations thereunder apply. A taxpayer seeking to change to a method of accounting permitted in paragraph (b)(14) of this section must secure the consent of the Commissioner in accordance with § 1.446–1(e) and follow the administrative procedures issued under § 1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to change its accounting method.

(m) *Effective/applicability date.* (1) Paragraphs (h)(2)(i)(D), (k), and (m)(1) of this section apply for taxable years ending on or after August 2, 2005.

(2) Paragraph (b)(14), the introductory phrase of paragraph (c)(4), the last sentence of paragraphs (e)(2)(i)(A) and (e)(2)(ii)(E), paragraph (l), and paragraph (m)(2) of this section apply to amounts paid or incurred (to acquire or produce property) in taxable years beginning on or after January 1, 2012. For the applicability of § 1.263A–1 to taxable years beginning before January 1, 2012, see § 1.263A–1 in effect prior to January 1, 2012 (§ 1.263A–1 as contained in 26 CFR part 1 edition revised as of April 1, 2011).

(3) *Expiration date.* The applicability of this section expires on December 23, 2014.

■ **Par. 34.** Section 1.1016–3 is amended by:

■ 1. Revising paragraphs (a)(1)(ii) and (j)(1).

■ 2. Adding paragraph (j)(3).

The addition and revision read as follows:

§ 1.1016–3 Exhaustion, wear and tear, obsolescence, amortization, and depletion for periods since February 13, 1913.

(a) * * *

(1) * * *

(ii) [Reserved]. For further guidance, see § 1.1016–3T(a)(1)(ii).

* * * * *

(j) * * *

(1) *In general.* [Reserved]. For further guidance, see § 1.1016–3T(j)(1).

* * * * *

(3) *Application of § 1.1016–3T(a)(1)(ii).* [Reserved]. For further guidance, see § 1.1016–3T(j)(3).

■ **Par. 35.** Section 1.1016–3T is added to read as follows:

§ 1.1016–3T Exhaustion, wear and tear, obsolescence, amortization, and depletion for periods since February 13, 1913 (temporary).

(a)(1)(i) [Reserved]. For further guidance, see § 1.1016–3(a)(1)(i).

(a)(1)(ii) The determination of the amount properly allowable for exhaustion, wear and tear, obsolescence, amortization, and depletion must be made on the basis of facts reasonably known to exist at the end of the taxable year. A taxpayer is not permitted to take advantage in a later year of the taxpayer's prior failure to take any such allowance or the taxpayer's taking an allowance plainly inadequate under the known facts in prior years. In the case of depreciation, if in prior years the taxpayer has consistently taken proper deductions under one method, the amount allowable for such prior years must not be increased even though a greater amount would have been allowable under another proper method. For rules governing losses on retirement or disposition of depreciable property, including rules for determining basis, see § 1.167(a)–8T, § 1.168(i)–1T, or § 1.168(i)–8T, as applicable. The application of this paragraph is illustrated by the following example:

Example. On July 1, 2011, A, a calendar-year taxpayer, purchased and placed in service ''off-the-shelf'' computer software at a cost of $36,000. This computer software is not an amortizable section 197 intangible. Pursuant to section 167(f)(1), the useful life of the computer software is 36 months. It has no salvage value. For 2011, A elected not to deduct the additional first year depreciation deduction provided by section 168(k). A did not deduct any depreciation for the computer software for 2011 and deducted depreciation of $12,000 for the computer software for 2012. As a result, the total amount of depreciation allowed for the computer software as of December 31, 2012, was $12,000. However, the total amount of depreciation allowable for the computer software as of December 31, 2012, is $18,000 ($6,000 for 2011 + $12,000 for 2012). As a result, the unrecovered cost of the computer software as of December 31, 2012, is $18,000 (cost of $36,000 less the depreciation allowable of $18,000 as of December 31, 2012). Accordingly, depreciation for 2013 for the computer software is $12,000 (unrecovered cost of $18,000 divided by the remaining useful life of 18 months as of January 1, 2013, multiplied by 12 full months in 2013).

(a)(2) through (i) [Reserved]. For further guidance, see § 1.1016–3(a)(2) through (i).

(j)(1) *In general.* Except as provided in paragraphs (j)(2) and (j)(3) of this section, this section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see § 1.1016–3 in effect prior to December 30, 2003 (§ 1.1016–3 as contained in 26 CFR part 1 edition revised as of April 1, 2003).

(2) [Reserved]. For further guidance, see § 1.1016–3(j)(2).

(3) *Application of § 1.1016–3T(a)(1)(ii).* Paragraph (a)(1)(ii) of this section applies to taxable years beginning on or after January 1, 2012. For the applicability of § 1.1016–3(a)(1)(ii) to taxable years beginning before January 1, 2012, see § 1.1016–3(a)(1)(ii) in effect prior to January 1, 2012 (§ 1.1016–3(a)(1)(ii) as contained in 26 CFR part 1 edition revised as of April 1, 2010).

(4) *Expiration date.* The applicability of this section expires on December 23, 2014.

Steven T. Miller,

Deputy Commissioner for Services and Enforcement.

Approved: December 5, 2011.

Emily S. McMahon,

(Acting) Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. 2011–32024 Filed 12–23–11; 8:45 am]

BILLING CODE 4830–01–P